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Islamic Microfinance
Theory, Policy and Practice

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1. Introduction

Programmes that provide credit and savings services have been promoted in recent years by governments, international development organisations as well as local non-governmental organisations (NGOs) and grassroots bodies as a key strategy for alleviating poverty in low-income countries (and increasingly also within poor communities in high income countries) and helping to achieve the Millennium Development Goals (MDGs) – indeed 2005 was designated as the 'Year of Microcredit' by the United Nations. At the same time there has been a proliferation of institutions providing credit and loans services to poor or disadvantaged sectors of the population. This has been accompanied by a burgeoning literature evaluating the impact of such programmes and offering advice to the service providers on how credit and savings schemes should be structured and programmes implemented.

However, very few of these initiatives have adhered to Islamic financing principles even when their work is undertaken in largely Muslim countries. Unsurprisingly, therefore, there is a paucity of literature documenting the success or otherwise of **Islamic** microfinance programmes. This, in turn, has meant that organisations wishing to create microfinance initiatives that conform to Islamic financing principles are faced with a distinct lack of guidance on how to establish and implement microfinance programmes. A great opportunity has been missed. Nevertheless, anecdotal evidence suggests that the demand for microfinance services based on Islamic principles is tremendous – there are, after all, around 1.3 billion Muslims worldwide. In the absence of successful microfinance programmes adhering to Islamic financing principles many Islamic donors have tended to shy away from such initiatives and concentrated instead on relief and rehabilitation programmes thereby limiting the resources available to those organisations wishing to implement Islamic microfinance programmes. At the same time, many Muslims refrain from using financial services that do not adhere to Islamic financing principles for fear of breaching their religious beliefs – certainly there is anecdotal evidence to suggest that the proportion of Muslims using financial services is less than their non-Muslim counterparts (El Hawary and Grais 2005). It would be reasonable to suppose, therefore, that the growth and development of many Muslim owned small businesses is constrained as a result of the unavailability of Islamic financial services.

The purpose of this document is to show how microfinance programmes based on Islamic financing principles can be established. It is hoped that this may encourage the provision of microfinance services that conform to Islamic financing principles and eventually, of course, the use of these services by microentrepreneurs. As well as providing a theoretical framework outlining the tenants upon which Islamic financing is based, this document provides practical advice on how such a programme may be structured, guidelines that can be followed when implementing a microfinance programme, as well as advice upon programme monitoring and evaluation. The target audience is organisations that wish to provide microfinance services that conform to Islamic financing principles. This document is, primarily, a practical manual written from a practioners perspective and it deals only fleetingly with theoretical issues relating to Islamic finance - these require a far greater understanding of Islamic law than the author possesses. Ultimately, simple, easy to use financing techniques that conform to such

principles will evolve through experience and experimentation over a period of time. However, imaginative and innovative research can no doubt accelerate this process.

This document draws upon the experience of Islamic Relief in promoting microfinance programmes in several countries, notably Bosnia and Herzegovina, Kosovo, Sudan and Pakistan with which the author is personally familiar. The programmes have differing aims, structures and organisations as well as modes of implementation and indeed there have been differing levels of success. The aim of this document is not to promote standardisation. Rather it is to provide assistance to those organisations wishing to modify their programmes or considering alternatives. For those organisations that do not have microfinance programmes but are considering such initiatives in the future then this document may assist them in creating, organising and implementing a microfinance programme. It should be stressed at the outset that there does not exist one unique microfinance model or method of delivery that should be promoted. Rather, **each microfinance programme needs to be tailored specifically to meet complex local realities prevalent within each country or even different regions within a country**.

This introductory section defines microfinance and distinguishes it from other commonly used terms such as microcredit and also explains why such programmes have become increasingly popular in recent years.

1.1 What is microfinance?

Microfinance refers to making small loans available to poor people (especially those traditionally excluded from financial services) through programmes designed specifically to meet their particular needs and circumstances. Typically, the characteristic features of microfinance programmes are that:

- Loans are usually relatively short term, less than 12 months in most instances, and generally for working capital with immediate regular weekly or monthly repayments – they are also disbursed quickly after approval, particularly for those seeking repeat loans.
- The traditional lender's requirements for physical collateral such as property are usually replaced by a system of collective guarantee (or solidarity) groups whose members are mutually responsible for ensuring that their individual loans are repaid.
- Loan application and disbursement procedures are designed to be helpful to low income borrowers – they are simple to understand, locally provided and quickly accessible.

It is useful to add a small but important clarification. In much of the literature, the terms microcredit, microfinance and microenterprise credit are often used interchangeably. There terms are, however, slightly distinct. Microcredit refers specifically to small loans, whereas the term microfinance should generally be used when lending institutions complement loans with other services such as, for example, savings, insurance and money transfer. The term "microenterprise credit" infers that all credit will be invested in the microenterprise and seems to ignore the issue of loan 'fungibility' (that is cash being used for other purposes). In the vast majority of instances the literature is essentially referring to just one category of micro financial service: microcredit for self-employment, this is often shortened to simply

microcredit. Despite being aware of this distinction, this paper will consistently use the term microfinance, rather than microcredit, since it more accurately describes the nature of the financing relationship between parties in Islam, even though essentially this document focuses upon the provision of small 'loans', rather than other services, to poor people.

1.2 Why is microfinance so popular?

Why have microfinance initiatives become so popular in recent years? The proponents of such programmes believe that access to small loans creates a virtuous cycle of investment and increased income that breaks the vicious cycle of poverty in which many poor people are trapped. It is argued that the infusion of credit creates opportunities for self-employment for poor borrowers and that this in turn augments their income and leads to increased consumption and investment. Continued access to credit and the process of increased investment increases income yet further. This theory suggests that as this cycle is continually repeated with successive loans the "poor" borrower will gradually climb out of poverty.

Although the theory underlying the promotion of microfinance is relatively easy to understand, why have a host of organisations (often including those with little previous specialist financial experience) seen it necessary to provide microfinance services to poor people? Why has this not been left simply to the specialist private commercial sector? The reasons lie with the reluctance of many commercial financial intermediaries, such as banks, to advance relatively small loans to large numbers of poor people. This reticence is based on a host of factors of varying importance. Poor people are often unable to provide the types of traditional collateral required by banks such as deeds for property; they may be illiterate and unable to complete the application forms; the distance to the nearest bank may be too far for them to travel both to complete the application forms as well as to make regular repayments; the size of loans required by poor people and the costs incurred in analysing and processing such loan applications may make them economically unattractive to banks; or poor people may be unemployed or without a regular or verifiable sources of income.

As a consequence poor people frequently rely on friends or family or private moneylenders as their principal sources of credit. Private moneylenders can offer several advantages that make their service convenient. They are often personally familiar with the borrower and therefore offer credit without collateral; they are generally located locally and can both disburse loans immediately with minimal paperwork as well as receive repayment without the need to travel great distances. Nevertheless, it is often the case that private moneylenders charge relatively high rates of interest and they may not be able to provide more than limited short-term capital. Therefore, and as a consequence of both the formal (banks) and informal (moneylenders) private commercial sector being unable to meet the micro financial demands of poor people, other microfinance providers such as NGOs, more often stimulated by social rather than commercial gain, are attracted to providing small loans and savings services.

It is also worth noting that the enthusiasm for microfinance among international donors has also arisen, in part, because microfinance for self-employment is in tune with the neo-liberal economic ideology of providing opportunities for individuals to help themselves through engaging in market activities. Furthermore, microfinance is also more appealing for donors

because it provides a more sustainable strategy, as loans should be repaid whereas grants are not.

1.3 Outline of this paper

This document relies heavily on the accumulated experience of Islamic Relief's microfinance programmes in four countries, namely Bosnia & Herzegovina, Kosovo, Pakistan and Sudan with which the author is personally familiar. Indeed, the examples provided are drawn almost exclusively from these countries. This paper is divided into nine chapters. Following this introductory chapter, chapter 2 provides a brief introduction to Islamic financing principles and lending methodologies that need to be considered when designing and operating an Islamic microfinance programme. Chapter 3 examines the importance of microfinance programme objectives and mission statements. It is essential that each microfinance programme has a clear organisational structure with clearly defined staff roles and responsibilities. Chapter 4 explores these issues with examples from Islamic Relief's microfinance programmes in the aforementioned countries. Chapter 5 discusses which types of lending methodology are most suitable to extending microfinance to relatively poor people, once again with examples. Chapter 6 provides practical advice that should be considered when selecting borrowers and assessing loan applications, while chapter 7 describes procedures for disbursing loans as well as collecting repayments. The issue of monitoring and evaluating the performance of microfinance programmes, with respect to both the service provider itself as well as on the lives of borrowers is explored in chapter 8.

2. Principles of Islamic finance

This chapter introduces the principles of Islamic finance and also attempts to provide a brief introduction to the different Islamic lending methodologies which tend to be far more interesting and complex than techniques used in conventional "western" lending which largely rely on charging interest. The basic principles and practices upon which Islamic financing is based date back to the early part of the seventh century – it is certainly not a new phenomenon. However, to begin a brief word on Islam and poverty. Hasan and Alamgir (2002: 145) describe how Islam views poverty as a religious and social problem that can push a person into "lowliness, sin and crime". The Prophet Muhammad (peace be upon him) sought Allah's refuge from it, "O Allah, I seek Your refuge from poverty, insufficiency and lowliness" (Abu Dawud), and linked poverty to disbelief, "Poverty is almost like disbelief in Allah" (Al-Bayhaqi). It is clear, therefore, that it is incumbent upon Muslims in general, and those working in an Islamic based development organisation in particular, to work towards the alleviation of poverty to build a secure and stable society.

The different Islamic financing methodologies are applicable according to the nature of commodity/business and the period for which the project will be financed. Before detailing the principal Islamic financing practices, however, we should remember that such methodologies are founded on the core belief that **money is not an earning asset in and of itself**. There are some general principles that are of particular importance for Islamic, or perhaps more precisely termed "*shariah* compliant", finance and these include:

- There must be some risk, whether funds are used in a commercial or productive venture.
- A financial transaction needs to have a "material finality", that is, it should be directly or indirectly linked to a real, tangible economic activity as opposed to financial speculation.
- The product or service that is bought or sold must be clear to both parties.
- There should be no funding of *haram* or sinful activities such as the production of alcoholic beverages or gambling, and funds should preferably finance socially productive activity. In broad terms, Islam forbids all forms of economic activity, which are morally or socially harmful.
- Financial risk must lie solely with the lenders of the capital and not with the manager or agents who work with the capital. Furthermore, a financial transaction should not lead to the exploitation of any party in the transaction.
- Interest is forbidden in that it is a predetermined, fixed sum owed to the lender irrespective of the outcome of the business venture in which the fund is used. This does not imply in any way that capital is free of charge or that it should be made available without any cost or that there should be absolutely no return on capital. Rather, a return on capital is allowed, provided that capital participates in the productive process and is exposed to business risk.
- It is not permitted to sell what one does not own – therefore "short-selling" (selling something that one does not own in the hope that it can be bought cheaper at a later date) is impermissible.

A general objective common to all Islamic finance should be to develop the economy within and according to Islamic principles. Furthermore, honesty and moral responsibility in Islamic finance contracts are indispensable ingredients of Islamic behaviour. As will become apparent from the following analysis according to Islamic financing principles there is in fact only one type of loan, namely *qard hasan*, the remaining mechanisms are strictly speaking financing arrangements. However, for the sake of convenience this paper does use the term 'loan' to describe the various lending methodologies. Before dedicating the remainder of this chapter to examining the various lending techniques, it may be useful to discuss a little further the prohibition of interest.

2.1 Riba

Riba is the Arabic word for the predetermined return on the use of money and it can be translated as "increase", "excess", or "usury". Although there is some discussion as to its exact meaning it is generally understood to mean interest. Most Muslim scholars believe that *riba* is prohibited, but there are subtle differences of interpretation. Thus, Siddiqui (1995 43-44) states that "a controversy has arisen that interest paid by banks on deposits or charged on advances is not tantamount to *riba* and is hence permissible". Soliman (2004: 277) reports on a fatwa issued by the Mufti of the Republic in Egypt that "ruled that the type of interest charged and received by conventional banks was in fact lawful from a religious standpoint". A small minority of scholars believe that interest should be prohibited only when money is lent at *exorbitant* interest rates (equivalent to usury rather than interest) that exploit the borrower. Thus, interest may be lawfully allowed under certain conditions such as a form of punishment for debtors (Dhumale and Sapcanin 1999).

However, without doubt the general consensus amongst Islamic scholars is that *riba* does in fact refer to **all** forms of interest. It is argued that *riba* is a sin under Islamic law, and even those hired to write the contract or who witness and thus confirm the contract are party to the sin. This prohibition extends to any and all forms of interest. The main arguments here are that Islam does not allow gain from a financial activity unless the financial capital is also exposed to the risk of potential loss; and that interest reinforces the tendency for wealth to accumulate in the hands of the few. Interest is considered an unjust instrument of financing. Thus, if the borrower's venture is unsuccessful through no fault of his or her own, it is unfair for the lender to consider a fixed rate of return or demand repayment; while if the borrower earns a very high rate of profit on the venture, it is unfair that the lender should receive only a small proportion of the profit even though he/she may well have provided the majority of the finance for the venture. Prohibition of *riba* means that money can only be lent lawfully for either charitable purposes (without any expectation of return above the amount of the principal), or for the purposes of doing lawful business, that is, investment on the basis of profit and risk sharing. Indeed, economic activity and prosperity are viewed as a religious virtue or even obligation in Islam, provided the activity conforms to *shariah*.

There are several passages in the Quran which quite clearly condemn the practice of *riba*:

"Those who devour riba will not stand except as he stands who has been driven to madness by the touch of Satan … Allah has permitted trade and forbidden riba … Allah will deprive riba of all blessing" (2:275-6)

"O ye who believe! Fear Allah, and give up what remains of your demand for riba, if you are indeed believers. If you do not, take notice of war from Allah" (2: 278-90)

The absolute prohibition of interest in the Quran is a command to establish an economic system from which all forms of exploitation are eliminated, in particular, the injustice of the financier being assured of a positive return without doing any work or sharing in the risk, while the entrepreneur, in spite of management and hard work, not being assured of a positive return.

The prohibition of interest is therefore a way to establish justice between the financier and the entrepreneur[1]. If a small business applies to an Islamic lender for finance, the lender should, in principle decide whether or not to support the project on the basis of a cost-benefit analysis of the scheme, not on the basis of collateral. Although the Quran prohibits the use of interest and encourages legitimate commerce, trade and wealth creation, it does not specify any commitment to particular types of contract. The following sections elaborate some of the principal financing techniques developed by Islamic lenders (for those interested in a more complete description of an exhaustive list of financing arrangements used by Islamic banks, particularly those in Iran and Pakistan, please see Ahmad 1993).

2.2 Murabaha

Murabaha is probably the most popular and widely used Islamic financing technique (Ahmad 1993) perhaps because it is relatively simple to apply, certainly when compared to other Islamic financing techniques which, as we will see later in this section, require more elaborate arrangements for their application. *Murabaha* involves the resale of a commodity, after adding a specific profit margin (often referred to as a 'mark-up') by the lender to the borrower who agrees to buy that commodity for the new offered price. Usually, repayment is made in instalments to the financier, who pays the price to the original supplier of the commodity.

This type of finance is commonly used for financing assets or working capital inputs, such as raw materials, machinery or equipment. For *murabaha* to be *shariah* compliant the financier must own (or procure) the commodity first and then resell it; the commodity should be a tangible one; and the buyer must know and then agree to the purchase and resale prices. When

[1] Christian and Jewish theologies also maintained traditions against usury. In the Old Testament, for example, it says: "If thou lend money to any of my people that is poor by thee, thou shalt not be to him as an usurer, neither shalt thou lay upon him usury. If thou at all take thy neighbour's raiment to pledge, thou shalt deliver it unto him by that the sun goeth down" Exodus (22: 25-26). In other words, not only is one not supposed to charge interest, but also if the collateral for a loan is in the form of a necessity like a coat, one must make sure that the borrower can still make use of it when it is needed. Anti-interest sentiment in the West existed as far back as Aristotle and was reinforced by the great Roman Catholic theologians, such as Augustine and Thomas Aquinas. There are further references against interest in Leviticus (25:35-37) and Deuteronomy (23:20). However, modern Christian and Jewish scholars have reinterpreted the term from its original meaning of "all" interest to "excessive" interest.

all these conditions are fulfilled, both parties sign a *murabaha* contract in which all terms and conditions are clearly stated. The collateral can be in the form of a mortgage on property, a bank guarantee, a third party guarantee, and so on, depending on the amount of the loan. The borrower often repays in equal instalments. Although this model may generate high initial transactions costs it is easy for borrowers and financiers to understand and simplifies loan administration and monitoring. The financier owns the goods purchased until the last instalment is repaid, whereupon ownership is transferred to the borrower.

There is some scepticism towards this particular mode of financing and indeed it has been argued that a fixed mark-up it is similar to interest. However, the mark-up is not in the nature of compensation for time or deferred payment, even though the entire cost had to be incurred because the entrepreneur did not have the necessary funds to make the purchase he or she wanted. Rather, the mark-up is for the services that the financier provides, namely, seeking out, locating, and purchasing the required goods at the best price. This is a recognised service which can be paid for and whose value is predetermined. Furthermore, the mark-up is not related to time since, if the entrepreneur is unable to pay during the agreed time, the amount of mark-up remains as fixed originally in the contract and does not increase due to a delay in the contract. Further, in obtaining the goods, the financier is taking a risk: the client may not accept the quality or price at which he or she purchased and the financier is then stuck with the goods. To ensure that this technique is not abused and remains *shariah* compliant the Bank of Sudan’s Sharia Council, for example, issued a *fatwa* in 1993 establishing key requirements that had to be met in order for a *murabaha* contract to be legal (Stiansen 2004). These include the entrepreneur submitting an application in detail describing the commodity to be purchased; the financier buying the commodity and physically taking possession; and the entrepreneur having the right to refuse to accept the commodity when offered sale by the financier.

2.3 Mudaraba

In a *mudaraba* contract two parties are involved; the financier, who provides all the money and the entrepreneur (or *mudarib*) who uses his or her skill to invest the money in an attractive business. In a *mudaraba* contract when a profit is realised, it is shared between the financier and the entrepreneur according to a pre-determined ratio. Importantly, profit-sharing rates must be determined only as a percentage of the profit and not as a lump sum payment. In the case of a loss, providing it has incurred in the normal process of business and not due to neglect or misconduct by the entrepreneur, the financier loses all his or her money, while the entrepreneur merely loses his or her time and effort. In cases of proven negligence or mismanagement by entrepreneurs, however, they may be held responsible for the financial losses. For this reason *mudaraba* contracts are considered to be very risky and require a great deal of confidence in the borrower. The entrepreneur does not invest anything in the business save his or her labour and should not claim any wage for conducting the business. These types of contracts are most common in investment projects in trade and commerce that are capable of achieving full operational status in a relatively short period.

One of the challenges in using this model for microfinance lending is the uncertainty of the profit. Most microentrepreneurs do not keep accurate accounts. How, then, should profits be calculated and distributed? Even when the level of profit is known, a borrower may have to

repay a different amount in each repayment period. This lack of simplicity – relative to equal repayment instalments – may be more difficult to understand for a lending organisation's loan officers (especially when he or she has one hundred or more loans to oversee) and borrowers alike when compared to, for example, *murabaha*.

Another form of *mudaraba* may occur when the roles are reversed, when an individual investor deposits money with the financier that becomes the *mudarib*. The investor may deposit his/her money in *mudaraba* bonds for a specific period of time while the financier invests the money in a profitable business, and then shares the resultant profit with the depositor. This is similar to time deposits in the western banking system. For a more detailed discussion of this method of financing see Siddiqi (1985).

2.4 Musharaka

Literally meaning partnership in Arabic, *musharaka* can perhaps best be understood in financing terms as an equity participation contract. However, although among all *shariah* scholars there is a consensus that the *musharaka* financing principle is legitimate they differ in their opinions with regard to the ratio of profits that can be charged in *musharaka* contracts. According to the Shafi and Maliki schools (*madhabs*) of thought, the entrepreneur and the financier should share profit and loss in the same proportion as their investment. In contrast, according to the Hanafi and Hanabli schools of thought any ratio of profit can be stipulated with the consent and agreement of the partners. Although the Hanafi school of thought also adds that if a partner stipulates that he or she will remain a sleeping partner throughout the term of *musharaka*, then his or her share of profit cannot be more than the ratio of investment. It is clear that even though business and trade in Islam is based on ease and leniency, in formulating financing arrangements it is important to try and follow the rules of one school of thought and not to combine the views of two or more *Madhabs* in a way that is not valid. In the case of the venture suffering a loss, however, all the Muslim jurists are unanimous in agreeing that each partner should suffer the loss exactly according to the ratio of his or her investment.

Musharaka can be used for assets or working capital. At the end of the production cycle, or season, the costs of production are deducted from the revenue, and a certain percentage is earmarked for management fees, while the rest is divided between the partners according to their percentage investment in the share capital or other agreed division. If the entrepreneur wholly manages the project, the management fees go to him her, in addition to his or her profit share. If the financier is involved in management, part of the fees are paid to the financier. Management fees usually range between 10-30% of profit, depending on the entrepreneur's bargaining power and the nature of the project (for example, if the activity requires special skills the share of the entrepreneur may be greater). Two or more partners may contribute to the capital and expertise of the investment. This type of transaction has traditionally been used to finance medium and long-term investment projects.

The main difference between *musharaka* and *mudaraba* is that under the latter the entrepreneur offers his or her labour and skills only, without any contribution in cash or kind, and any losses are borne entirely by the financier. A *musharaka* can be continuous (to the end

of a project’s life span) or it can be a diminishing partnership, in which case the entrepreneur is allowed to buy out the financier’s share gradually.

As hinted at above, an Islamic lender may face several problems when promoting successful partnership finance. For example, many small firms often lack the necessary bookkeeping or they may try to conceal actual profits or report greater losses than actually experience, we cannot assume that all entrepreneurs will necessarily be good Muslims! A further problem facing Islamic lenders is the burden in terms of time and cost of monitoring and following up the partnership transactions. Building a relationship and conducting business using Islamic financing techniques requires much effort and resources. This is because such business is built on trust and confidence through personal relationships and these usually take time to establish.

Nevertheless, partnership financing for small enterprise has various advantages, the most obvious being the protection of the lender against inflation. It also avoids the necessity of demanding repayment from people who have already lost their livelihood. The unique feature of *musharaka* is that the lender shares profits as well as losses with the borrower, and hence shares business risk. The lender is obliged to monitor the business closely, and take part in marketing, and this no doubt broadens their understanding and develops their business skills. One important advantage of *musharaka* is that the entrepreneur does not have to contribute in cash to the proposed investment. Their share might in kind (inputs), labour, and rent of machines or equipment. Also they are rewarded for their entrepreneurship, since in relatively profitable ventures the return on investment is much higher than other modes of finance.

Ahmad (1993) provides the example of how the Sudanese Islamic Bank have developed a *musharaka* contract in which the bank provides farmers with certain fixed assets such as ploughs, tractors, irrigation pumps, etc. and some working capital such as fuel, seeds, pesticides and fertilizers. The farmer’s equity is confined to providing land, labour and management. Since it is a partnership contract, there is no need of collateral or guarantees other than personal guarantees. Profits are shared between the farmer and the bank in such a way that the farmer is first paid 30% of the net profit as compensation for his management, and then the remaining 70% is shared between the bank and the farmer on a pro rata basis based on each partner’s respective share in the equity.

2.5 Ijarah

Ijarah is a contemporary lending methodology that has been increasingly adopted by Islamic lenders and is similar to the concept of leasing. Under this arrangement an entrepreneur short of funds may approach the financier to fund the purchase of a productive asset. The financier may do so by buying the productive asset and renting it out to the entrepreneur. The asset remains in the ownership of the financier who is responsible for its maintenance so that it continues to give the service for which it was rented. The *ijarah* contract is terminated as soon as the asset ceases to give the service for which it was rented or the leasing period comes to an end and the physical possession of the asset and the right of use revert back to the financier. In specific cases the entrepreneur can make regular payments and become the owner of the financed equipment once he or she has paid all agreed instalments. The latter transactions are referred to as *ijarah wa iqtina* or lease purchase arrangements.

Importantly and like any other contract, a lease contract has to fulfil all of the conditions of a valid contract stipulated by the *shariah*. Thus, the contract should be clear, should be by mutual agreement, the responsibilities and benefits of both parties should be clearly detailed; the agreement should be for a known period and price, etc.

2.6 Qard hasan

The Quran clearly encourages Muslims to provide *qard hasan* or benevolent loans to "those who need them":

> *Who is he that will give Allah qard al hasan? For Allah will increase it manifold to his credit. (57:11)*
>
> *If you give Allah qard al hasan … he will grant you forgiveness. (64:17)*
>
> *Establish regular prayer and give regular charity and give Allah qard al hasan. (73:20)*

In such loans the borrower should only repay the principal, although certain scholars allow the lender to cover the administrative costs incurred in disbursing the loan as well. The service charges are not profit, they are actual costs in respect of such items as office rent, salaries, stationary, etc. Islamic law allows a lender to recover from the borrower the costs of the operation over and above the principal. However, an important condition attached to such charges to prevent them becoming equivalent to interest is that the commission or charge cannot be made proportional to the amount or to the term of the loan. In practice, such service fees are frequently in the range of 2-4% of the loan amount (for example the Islamic Development Bank Jeddah in Saudi Arabia charges 2-3%, Hossain 2002). Importantly, this figure is arrived at after due calculation of administrative costs actually incurred rather than an assumed percentage. Banks in Pakistan are authorised to provide loans on the basis of service charges that are considered permissible under *shariah* provided they are not related to the amount of the loan and are related to actual administrative expenses. In Pakistan, the maximum service charge on loans for a given period is calculated using the following formula (from Ahmad 1993):

Service charge: (E/A) x 100

Where

E: administrative expenses during the year

A: average assets during the year

Who should receive *qard hasan* loans? The practices of various Islamic lenders differ in this respect. Some Islamic banks only provide *qard hasan* loans to those who are existing clients of the bank, while others restrict such loans to weak or needy sections of society. However, other lending institutions extend this service to include small producers, farmers or entrepreneurs who are unable to receive finance from other commercial banks or other lending institutions.

2.7 Other Islamic financing mechanisms

Other lending contracts used in Islamic financing, and that can perhaps be used in microfinance programmes, include ***musaqat***, which is a specific type of *musharaka* contract for orchards in which the harvest is shared among all the equity partners according to their contributions. For example, under such a contract a bank may provide a farmer with orchards, gardens or trees which they own or which are otherwise in their possession. This is done for the purpose of gathering the harvest of the orchard or garden and dividing it in a specified ratio. The harvest may be the fruit, leaves, flowers, etc., of the trees or plants in the orchard or garden. A ***muzar'ah*** contract is essentially a *mudaraba* contract in farming where the financier can provide land or funds in return for a share of the harvest. Thus, banks in Iran for example are allowed to hand over to farmers land which they own or which is otherwise in their possession. The plot of land has to be completely specified and must be given for a specific period and the bank and the farmer share the output in an agreed proportion. Islamic financiers always have, of course, the option of **direct investment** through establishing and managing enterprises and purchasing equity capital in other enterprises.

A particularly popular financing mechanism used by Islamic banks in Pakistan is the **buy-back** of assets in which a movable or immovable asset is sold to the bank and is bought back by the entrepreneur for another price. It can perhaps best be illustrated with use of an example. An entrepreneur may agree to sell for cash to the bank for a specified sum of money raw materials, finished products, spare parts, machinery, etc, which he/she owns. The price paid by the bank to the client is called the sale price and is a given percentage of the value of the stocks sold to the bank. The entrepreneur immediately repurchases the same goods back from the bank for an amount equivalent to the sale price plus an agreed mark-up at what is called the purchase price. The entrepreneur has to repay the purchase price to the bank on a certain date in the future or in equal instalments. In most cases, for security the same goods are pledged to the bank. This method of financing has been adapted to finance the purchase/construction of a house or apartment. However, there are serious reservations among scholars regarding the validity of buy-back arrangements, particularly if there is no real transfer or ownership of goods when the contracts are put into effect.

In order to provide working capital to enterprises, Banks in Iran are empowered to purchase future output by paying the price in advance. Such transactions are usually known as ***bay' salam*** or forward sales. In such arrangements the specification and characteristics of the output must be determined as accurately as possible at the time of the contract. Similarly, the price agreed upon should not exceed the prevalent market price. Banks are not allowed to sell the products acquired, unless they are in physical possession of the goods and the duration of this transaction is usually a production cycle or one year, whichever is shorter.

The need to conform to certain religious principles affects the structure and development of Islamic microfinance programmes. It is essential, therefore, to seek approval from qualified Islamic scholars when implementing such programmes and particularly before developing new financial instruments – indeed most Islamic banks have standing religious boards and *shariah* advisors for this purpose.

In conclusion it is worth emphasising that Islam has not prescribed specific forms of financing; rather it has set some broad principles which can accommodate various forms and procedures. A new form or procedure of financing cannot be rejected merely because it has no precedent in the past. In fact, new forms of financing can be acceptable to the *shariah* in so far as they do not violate basic principles laid down by the Holy Quran, the *sunnah* or the consensus of the Muslim jurists.

2.8 Guarantees

The issue of how microfinance programmes overcome a poor person's lack of traditional collateral is explored in detail in section 5. Suffice at this stage to remember that Islamic lenders need to exercise care when considering whether they have adequate guarantees in place when deciding to finance a project, as there is no penalty for late payment under Islamic law (although religious advisory boards of certain banks have accepted fines for late payments as being in conformity with Islamic law, see for example Soliman (2004) for a discussion in the Egyptian context). Indeed Muslims are encouraged to allow borrowers further time to repay (see section 7.5). Some borrowers may try to take advantage of the fact that an Islamic lender is not able to charge interest on late payments. However, in the case of a borrower's failure to repay the loan at the agreed time, it is permitted to ask the guarantor to repay on the borrower's behalf or to effect the sale or transfer of collateral used to secure the loan. It is also worth reminding borrowers that it is incumbent upon Muslims to repay on time, indeed the Prophet Muhammad (peace be upon him) said, "procrastination (delay) in repaying debts by a wealthy person is injustice" (narrated by Abu Huraira and reported in Bukhari). In brief, when a debt is due the creditor can request repayment, if the debtor is solvent but delays repayment the creditor is permitted to seek legal redress.

The aim in this chapter has been to provide a theoretical introduction to the principles of Islamic finance and the various lending methodologies that can be adopted by Islamic microfinance institutions. However, before describing in detail how these principles and lending methodologies can be used in practice to actually organise, structure and implement a microfinance programme, it is important to that the programme have clear objectives and consider whether these are in fact best achieved through the provision of microfinance. These are issues are briefly addressed in the next chapter.

3. Programme objectives

Microfinance programmes have differing objectives although for many NGOs social objectives, such as reducing poverty or empowering women borrowers, are often prominent. The arguments for promoting microfinance programmes are relatively easy to demonstrate. It is argued that microfinance programmes assist borrowers by stabilising their existing income or generating additional income, by creating opportunities to earn independent incomes, by facilitating consumption smoothing and responding to the demand for precautionary savings. This strengthens the economic roles of borrowers and increases household income. In the case of women borrowers in particular, proponents of microfinance programmes argue that by increasing women's access to microfinance and thereby strengthening women's ability to control their assets and income, projects contribute to improving women's self-esteem and their status, both within the household and in the wider community, as independent producers and providers of a valuable cash resource to the household economy. It is further argued that increases in women's incomes improve the health, nutritional and educational status of other household members, particularly children.

3.1 Is microfinance actually needed?

Before considering how to design a microfinance programme or even draw up the programme objectives it is necessary to ask the question, **is the provision of microfinance the best way to respond to the needs of the poor people targeted for assistance**? Although microfinance can be a powerful tool in the battle against poverty, on its own it cannot eliminate poverty, and it is certainly no panacea.

Bundell (1998) asks a number of useful questions in this regard. Since the primary purpose of microfinance programmes is to provide loans for the poor for investment in productive activities in order to increase their income, it is necessary to ask, **are profitable, productive activities actually possible in the local context?** Do the targeted poor people have the necessary skills to engage in income generating activities? Since poverty is often characterised by fluctuations in income and earning power often influenced by the seasonality of the rural economy, the primary need may not be for an increase in income but rather for security of access to an income when it is required. In this situation then, microfinance for income generation may not be the most appropriate response - maybe the availability of microfinance for consumption smoothing may be more appropriate. Furthermore, if a microfinance programme is to succeed it also needs to be competently planned and managed, therefore it is also necessary to consider the question, **will the implementing organisation be sufficiently competent to administer such a programme?**

It should be noted that Islam discourages debt, heavy debt in particular, as much as possible – indeed it is something that is considered to have a serious and direct effect on a Muslim's belief or conviction because it can lead to negative consequences. The Prophet Muhammed (peace be upon him) used to regularly supplicate "Allah, I seek refuge with You from sin and heavy debt". When someone remarked "how often you seek refuge from heavy debt", he replied "when a man gets into debt, he speaks and tells lies, and he makes a promise and breaks it" (Bukhari and Muslim). The Prophet Muhammed (Peace be upon him) also said,

"Whoever dies free from three things – arrogance, cheating and debt – will enter Paradise" (Tirmidhi), and "The soul of a believer is held hostage by his debt in his grave until it is paid off" (Tirmidhi). Clearly assuming debt is a serious matter and should not be taken on except in cases of real necessity. Furthermore, it is incumbent upon on those providing finance to do so in a responsible manner and not overburden borrowers.

Only after considering such important questions and provisos, and if it is indeed decided that a microfinance programme is in fact the most appropriate response, should a programme actually be designed and implemented. The remainder of this document addresses these issues.

3.2 Mission statement

At the outset a microfinance programme should clearly formulate its own objectives and preferably articulate a mission statement. The mission statement and objectives should be drawn up together with local staff and after consultations with the target groups. The mission statement should clearly indicate the principal objectives of the microfinance programme. The following, for example, is the original mission statement of Islamic Relief's Business Loans Programme in Bosnia & Herzegovina.

> *The aim of the microfinance programme is to alleviate poverty through the provision of microfinance services to assist in the creation of income and employment generation opportunities for local microenterprises in the minority return areas of Bosnia & Herzegovina. It is hoped that this will contribute to improving the economic, social and political welfare of programme participants, their families and the local community.*

The mission statement of the Housing Loans Programme in Bosnia & Herzegovina is as follows:

> *The aim of the housing loans programme is to provide loans for the repair and reconstruction of war damaged housing as well as the construction of new houses. Although, the programme will target poor persons in general, it will in particular target minority returnees, internally displaced persons as well as women headed households who are unable to return to their pre-war homes.*

The importance of the mission statement cannot be overstated. It acts as a guide to the work of the microfinance programme, clearly stating the aims of the programme; the mechanisms used and target groups. When there is confusion regarding the suitability of lending, we can always refer back to a clear and unambiguous mission statement. Typically, the relevance of the mission statement will be re-examined as a microfinance programme or institution expands and there is an increasing emphasis on financial sustainability of the institution itself. Generally, the challenge for microfinance programmes is to expand or "scale-up" without losing sight of their original social missions.

3.3 What are poor people's previous and current experiences with credit?

Credit will not be a new experience to even the poorest members of a community. Most poor people already borrow from friends, relatives, local moneylenders, even other NGOs and commercial institutions such as banks. A microfinance programme should therefore be designed to take into account the existing knowledge and understanding of a community. There may, for example, be resistance from other institutions or existing moneylenders. Of course, it may be the case that a suitable and accessible microfinance programme is already in existence in which case it may be more appropriate to provide assistance to it rather than start a new scheme altogether. It is important to understand the market and potential borrowers before a programme is designed. Formulating the terms and conditions of the loans, the method of delivery, and how it fits in with the overall financial structure for potential borrowers should be based on information derived from assessments of the financial landscape (that is the range of credit, savings and other financial services on offer by all other financial intermediaries). It is critical therefore to conduct a market assessment when designing and launching a microfinance programme and thereafter continually reappraise the services on offer in relation to those offered by other financial intermediaries (Appendix 2 shows, for example, the costs of obtaining a loan from Islamic Relief in comparison with other microfinance organisations as well as commercial banks in Bosnia & Herzegovina).

Having decided that the provision of loans is indeed the most cost effective method of responding to poor people's needs, and that loans are best provided through creating a separate microfinance programme, how should such a programme be organised and structured? These are issues that are addressed in the next chapter.

4. Organisational structure

A microfinance programme should have an organisational structure with clearly defined staff roles and responsibilities. This chapter provides brief descriptions of the structure of Islamic Relief's microfinance programmes in Bosnia & Herzegovina, Pakistan and Kosovo. The organogram in Appendix 1 at the end of this document show how programme staff, in general, are structured while job descriptions of each of the key positions can be found in Appendix 10.

4.1 Programme staff structure

Islamic Relief's microfinance programmes tend to have similar staff structures. The programme is headed by a microfinance coordinator who is supported by an accountant, a cashier, and one or more drivers and administrative assistants. At the centre of the programme, however, are the loan officers. In general, there is one loan officer for every 120 loans or so, although this ratio can increase or decrease depending upon the complexity of the financing technology. Islamic Relief Pakistan employs specialist procurement staff that buy and deliver all materials and equipment associated with disbursing *murabaha* loans. In other programmes the loan officers themselves assume this task.

Each staff member has a clearly defined role and responsibilities. A microfinance specialist oversees the overall operations of the programme, providing guidance on how the programme should operate, how it should be structured, and guidance on future development. The microfinance coordinator is responsible for overseeing the day-to-day operations of the programme, while the accountant, administrative assistant and driver are essentially support staff. The programme revolves around the loan officers. The latter receive loan applications, investigate their feasibility, approve or reject proposals and often disburse loans and collect repayments as well.

Although each loan officer is not restricted as to the area he/she can take an interest in (in fact they are encouraged to take an interest in other regions, and programme performance in general), applications for loans from specific geographical areas must come through the loan officers responsible for that particular region.

Promotion of the microfinance programme, loan processing, and loan monitoring and recovery are the responsibility of the microfinance loan officers. They may be assisted in loan recovery (collecting loan repayments) by local loan co-ordinators (see box 5 below), however primary responsibility rests with loan officers and they are responsible for repayment rates in their regions. Each loan officer is also responsible for the activities undertaken by local loan co-ordinators in his/her region.

It is the responsibility of loan officers to evaluate loan proposals and advise on their feasibility. However, final decisions regarding whether a loan is to be approved or rejected should rest with a Loans Approval Committee. This should be comprised of at least 3 members, one of whom should be the Microfinance Co-ordinator. The loan officer who has visited and completed the application form should always present it. The Loan Approval

Committee considers screened applications for approval. The final decision as to whether to approve or reject a particular loan application rests with the Loans Approval Committee. Once approved, loan officers are also responsible for supervision of loan use and to ensure repayment as per schedule. The Loan Approval Committee can either have regular meetings at fixed intervals, every week for example, or meet as often as is necessary. Thus, in Bosnia & Herzegovina and Kosovo, Islamic Relief's Loan Approval Committee may convene as often as every day when applications and disbursements are at their height during the early spring.

Receipts must be issued by local loan co-ordinators when repayments are received from borrowers, and once again when they hand over repayments to loan officers. All repayments must be handed over at the first possible opportunity to the programme accountant who will issue a receipt for all funds received. The accountant is responsible for producing weekly statistics showing all monies disbursed and repayment rates for all loans according to geographical regions.

In general, although loan officers receive guidance on some important decisions, they are also given freedom to decide about many issues directly relevant to them. Indeed for an organisation to be truly participatory, programme staff and borrowers should of course have some involvement in decision-making, although there are limits to the their authority. Overly rigid structures and decision-making can prevent staff or borrowers' views from being heard. Staff should be encouraged to speak quite frankly in all meetings relating to the microfinance programmes.

It is important to emphasise that successful implementation of even the most clear and well-designed microfinance policies and programmes ultimately depends upon the extent to which programme staff understand and accept and perhaps even identify with theses policies. Clearly, therefore, **the success or failure of the microfinance programme is dependent in large part upon the capacity of programme staff.** While this is true of all microfinance programmes it is particularly pertinent in the case of Islamic initiatives since they generally involve more complex procedures and frequently require a greater input and understanding of loan-financed activities. It is necessary to ensure, therefore, that not only should staff receive adequate training but also that this process is ongoing. It is important that funds are allocated also for institutional capacity building and strengthening and not just for on-lending.

All staff working in Islamic Relief's microfinance programmes receive on the job training and are encouraged to have a broad understanding of the main issues that affect all aspects of their work – it is important that changes and suggestions as to how work can be improved come from below as much as from above. The programmes are constantly evolving as modifications and changes are made to better serve borrowers and also improve the efficiency and performance of the microfinance programmes themselves. Equally important is the need to receive qualified advice from experienced microfinance specialists in creating, implementing and evaluating and modifying microfinance programmes.

4.2 Ensuring legal compliance

Each microfinance programme should have the services of a locally qualified and registered lawyer readily available to ensure that the operations of the microfinance programme are at all times complying with the prevalent local legislation. Selecting a lawyer is an important step and should not be taken lightly, as he/she will play a key role in influencing the success or otherwise of the programme. Obviously, borrowers who have wilfully defaulted on their payments should have their cases referred to the lawyer. However, the lawyer should also be consulted on all the accompanying loan documentation forms and their exact wording. Since the legal requirements will differ between countries it is important that we tailor our loan documentation so that it is appropriate to differing local environments. Appendices 5-9 contain the Loan Agreement, Guarantor's Statement, Administrative Ban, Promissory Note and Borrower Declaration respectively that are used by Islamic Relief in Bosnia and Herzegovina and Kosovo. All these documents have been formulated with the assistance of Islamic Relief's local lawyers and are tailored to meet specific local legal requirements. Islamic Relief's lawyer in Bosnia & Herzegovina receives a fixed monthly salary that does not vary providing the number of cases of borrowers who have wilfully defaulted and referred by Islamic Relief to his offices does not exceed an agreed limit.

It is important to stress that since the loan agreement is a contract, it should also conform to the same principles that are applicable to other Islamic transactions. Briefly, these principles are as follows:

1. Both parties should be legally capable to enter into the contract.
2. The offer (*ijab*) and acceptance (*qabul*) must be clearly indicated in the contract.
3. The dates of payments must be clearly specified in the contract.
4. The loan agreement should be written down. The Quran states:

> *O you who believe! When you deal with each other in transactions involving future obligations for a fixed period of time reduce them in writing. (2:282)*

5. There should be at least two witnesses.

Once the contract is agreed, all parties should abide by its terms and conditions. The Quran clearly places importance on this:

> *O you who believe, fulfil your contract (5:1)*

> *And fulfil your covenant, for every covenant will be inquired into (17:34)*

> *And so (we punish them) for the breaking of their covenant (4:155)*

4.3 Creating a specialist microfinance organisation

Islamic Relief Bosnia & Herzegovina created and registered a specialist microfinance organisation, called First Islamic in early 2001. Islamic Relief Kosovo also has a separate microfinance organisation called START that was created in 2002. Both organisations were created in response to local legislation that prohibited organisations other than specialist registered microfinance institutions from disbursing loans. Effectively this meant that national and international non-governmental organisations had to develop separate microfinance institutions to disburse loans. Although both First Islamic and START are subject to local legislation, particularly with regard to financial reporting and auditing, they are wholly owned and administered by Islamic Relief. In contrast, the Small Scale Enterprise Development (SSED) Programme is not registered as a separate entity and is simply one of many programmes in various sectors implemented by Islamic Relief Pakistan.

The creation of First Islamic, START and the SSED has acted to separate microfinance activities from Islamic Relief's other work in Bosnia and Herzegovina, Kosovo and Pakistan respectively which included the reconstruction of houses, schools and clinics, sponsorship of orphans and emergency food distribution. A number of measures acted to create this separation. For example, different staff members are involved in different projects, and different headed notepaper and separate offices within the same building are used. All this has helped to create this "separate but same" identity. This is extremely important. Although, the different types of activities are often implemented in the same geographic regions, beneficiaries do not confuse loans from Islamic Relief's various microfinance initiatives, which have to repaid, with, for example, donations of materials for reconstruction of damaged housing or food distribution, which do not. There is always a danger that borrowers will see loans as something that does not need to be repaid, especially if the same organisation is also implementing other projects that involve donations. **Successfully combining a microfinance programme with other essentially humanitarian work within the same country programme is a difficult task** and something that perhaps should not always be attempted.

4.4 Investigating the possibility of other credit and savings initiatives – ROSCAS and partnerships with other financial intermediaries

It may be that instigating a microfinance programme is not the best way to assist poor people, even when the aim is to increase their access to small loans. An alternative to creating a specialist microfinance organisation is to create microfinance initiatives owned and managed by groups of poor people themselves such as community banks and rotating savings and credit associations (ROSCAS). It is, therefore, important, to investigate the possibility of promoting other credit and savings initiatives. Often, local communities may have even already had some experience in small revolving savings and loans schemes.

To promote such initiatives in practice usually requires that the people are already organised into community groups and already have the benefit of common problem solving and cooperative action. They can be encouraged come together to set up a common scheme with their own elected representatives with pooled savings and rules which have been discussed and agreed among members of the group themselves.

The relative disadvantages of this approach are that it takes time to establish and involves a great deal of capacity building with group members. Furthermore, the scale of any such initiative will invariably be limited by the group's own management abilities. However, there are also significant advantages. The involvement of poor people and their ownership of a successful institution can provide not only economic benefits but also promote the collective empowerment that comes from organisation. Poverty is characterised by vulnerability, powerlessness and dependency as well as lack of income. Collective organisation and ownership of wealth can address the psychological consequences of being poor and challenge the wider structures of society that are considered unfair.

Another alternative is to partner with other financial intermediaries, such as commercial banks. Thus, Islamic Relief signed an agreement with the Savings and Social Development Bank (SSDB) in 2006 to jointly fund a small business loans programme in Sudan. The scheme targets widows, specifically the mothers of orphans sponsored by Islamic Relief's one-to-one sponsorship programme.

The SSDB, a commercial bank, agreed to contribute 50% of whatever amount Islamic Relief deposited with the bank towards lending. Women were divided into groups varying in size between 15-28 members. Groups were formed by women living in local communities in close proximity to each other. Each group elected a chairwomen, treasurer, and secretary and a further three women without specific function to form the group executive committee. This committee was entrusted with analysing and nominating loan proposals to the SSDB for consideration. All ex-com members were then given a three-week training course on group formation, organisation and management; bookkeeping and analysing loan application. The training was undertaken jointly by SSDB and Islamic Relief staff.

For successful proposals *murabaha* loans are given for generally short periods of between 1-6 months with fixed monthly repayments. Borrowers identify the item (s) they wish to acquire and are then accompanied by a bank officer to purchase the item (s). There is a fixed fee of 15% (stipulated by the Central Bank of Sudan) on all *murabaha* loans. Repayments are made at SSDB branch offices. The incentive to participate for the bank is clear: not only can it make a profit on lending, but the capital it is lending is largely not its own.

Each group member deposits the sum of 5 Sudanese pounds (approximately 2 euros) monthly into a group savings account held with the SSDB. Each member also pays an initial 2 pounds to join the group and a further 2 pounds each time they wish to make a loan application and both fees are added to the group savings account. When an individual loan is disbursed to a member the group issues a cheque against its group savings account for the totality of the loan that, in the event of wilful default, the bank has the ability to cash. It is, therefore, the group savings account which acts as the guarantee for the loan.

Islamic Relief decided to work through the SSDB rather than disburse loans directly for several reasons of varying importance. Firstly, the SSDB agreed to jointly fund any lending programme thereby increasing the total amount of available funds. Secondly, the SSDB had specialist staff already well versed in lending to microentrepreneurs in the geographical areas

targeted by Islamic Relief. Thirdly, it was felt that potential borrowers had an image of Islamic Relief as an essentially humanitarian organisation that provided donations (particularly since all potential borrowers received a monthly stipend from Islamic Relief), rather than as a developmental organisation or financial intermediary and that under the circumstances it would be difficult to convince borrowers to repay. By contrast, it was felt that borrowers would be less likely to willingly default with loans from the SSDB.

In the last two chapters we have addressed issues surrounding having clear programme objectives and sound organisational structure. In the next chapter we provide practical examples of how the Islamic lending methodologies introduced in chapter 2 can be applied to providing microfinance.

5. Lending methodologies

Chapter 2 has already outlined the principal Islamic financing methods. However, which of these methods is most applicable to extending **microfinance**? In attempting to answer this question this chapter explains the lending methodologies adopted by Islamic Relief's microfinance programmes in Bosnia & Herzegovina, Kosovo, Pakistan and Sudan. It complements explanations with specific examples of each type of loan given. Individual microfinance programmes must decide which methodology or combination of methodologies is most applicable in their own particular environment. This in turn will depend upon factors such as the type of activities funded by loans, the proximity of borrowers, etc.

5.1 Individual or group loans?

Before discussing loan methodologies, however, it is perhaps appropriate to begin with a word of clarification between individual or group loans. Poor people often cannot offer traditional collateral such as property as guarantees for their loans often simply because they have little or no property to offer. Even when they do have property the cost of offering it as collateral for a loan may be too expensive, Thus, in Bosnia & Herzegovina for example the presiding court must assess the value of the property in cases where it is offered as collateral (as is frequently the case with commercial banks) and charges around 250 euros for the privilege of doing so. In cases where the borrower is seeking a loan of just 500 euros this is obviously unattractive. As a response to poor people's inability to offer traditional collateral microfinance programmes have increasingly focused on replacing the use of physical collateral for individual loans with group responsibility. With group lending, instead of lending directly to individual borrowers, the microfinance organisation lends to groups of borrowers (commonly small groups of 4-5 people often called solidarity groups) who are jointly liable for repayment.

Group lending has been widely adopted by many microfinance institutions throughout the world. What explains the success of group lending? There are several reasons and each many play a role of varying significance depending upon the context:

- Peer Monitoring: the ability of borrowers to monitor the investment behaviour of one another during the course of a loan, making sure that each borrower only undertakes safe investment projects with the loan monies.
- Social Ties: the social cohesion that exists in some communities means that the sanctions that a borrower would receive from the group for defaulting results in each member wanting to repay faithfully.
- Group Pressure: the pressure between borrowers to repay means that the group can expel non-paying members if they default, thus excluding them from continued access to credit.

However, while the success of group lending in some parts of the world such as Bangladesh has led to its adoption by microfinance institutions across Asia, Africa and Latin America, it may be difficult to promote group lending in regions where social ties are not necessarily high. Furthermore, many entrepreneurs are individualistic, they may not like working in groups and

they may also compete with each other and be unwilling to share confidential information with potential competitors (there is also increasing evidence of the negative impacts on individual group members from group lending, for example see Rahman 2001). Consequently, in Islamic Relief's microfinance programmes individual loans are given based on a combination of personal guarantors, group savings accounts, as well as co-signers and community recommendations to ensure repayment. These guarantee mechanisms have worked well and repayment levels in all programmes at the time of writing are in the range of 95-99%. Careful thought, therefore, needs to be given whether group lending is indeed the best guarantee mechanism or whether other mechanisms are more appropriate.

As we have already seen in chapter 2 a variety of Islamic financing mechanisms can be used disburse loans. Islamic Relief has utilised a variety of Islamic financing techniques to support thousands of microenterprises engaged in small-scale commerce, manufacturing and agriculture. The techniques employed are explained once again in the following paragraphs with examples from actual programmes.

5.2 Murabaha loans given by Islamic Relief

Islamic Relief Bosnia & Herzegovina initiated its microfinance activities with *murabaha* loans in 1998. Borrowers were provided with pregnant heifers, initially Holstein-Friesian but later Simmental varieties, imported from Germany by Islamic Relief. It was hoped that borrowers would be able to generate income and repay the loan not only from the sale of milk, cheese and yoghurt but also from selling one or more of the calves subsequently produced.

Undoubtedly a significant number of borrowers benefited from the loans. However, the project was extremely expensive for Islamic Relief to administer. Many problems stemmed from poor monitoring and control. Thus, borrowers were unfamiliar with the intensive animal husbandry techniques required by these varieties of cows. With proper planning and reasonable foresight such problems could have been avoided. However, other difficulties arose from problems that are intrinsic with this type of loan. Extreme care needs to be taken when providing loans in kind as the financier is open to blame for supplying sub-standard products. In this particular case borrowers believed, often incorrectly, that Islamic Relief provided them with poor quality cows that were not producing high quantities of milk and were difficult to successfully inseminate. As Islamic Relief provided the cows borrowers argued they should also accept part of the blame for non-repayment. This led many borrowers to default on their loans. It is important to stress that when the financier provides the goods they are also then held responsible by borrowers for the quality of those goods, this is especially problematic in the case of livestock were it is easy for the borrower to blame the poor quality of the animal as the cause of non-repayment.

Presently and in order to avoid such liability problems, Islamic Relief requests borrowers to identify the item they wish to purchase and then typically a loan officer or procurement officer from Islamic Relief then makes the purchase on their behalf. The item is then delivered to the borrower by Islamic Relief. *Murabaha* types of loan are perhaps easier to administer when the purchase is of machinery or raw material rather than livestock as the following example shows.

Box 1 – Murabaha financing

Senad Bajrakterevic is a graphic design engineer who lives in Doboj-East Municipality in northern Bosnia & Herzegovina. Shortly before the start of the Bosnian War he had opened a private graphic design business in partnership with his brother. During the war his equipment was destroyed and his business ruined. Nevertheless, after the end of war he decided to try and re-open his business. He needed an industrial printing press for publishing. One of Islamic Relief's loan officers identified a second hand press that was for sale and arranged for an inspection with Senad to verify its condition. Once Senad had expressed his satisfaction with the machinery, Islamic Relief negotiated a price with the seller and the costs of transporting the same to Senad's workshop and once again informed Senad. Since he was satisfied with the total price, Islamic Relief arranged to buy and transport the printing press and gave it to Senad. Both parties signed an agreement in which it was clearly stated the total amount to be repaid by Senad to Islamic Relief for finding, purchasing and transporting the printing press. The printing press remained the property of Islamic Relief until such time as Senad had completely repaid the loan. Since this time Senad has received and repaid 2 further loans from Islamic Relief to buy computers and enlarge his workshop. His business now employs several family members and offers a range of graphic design services ranging from printing and designing business cards to books.

Nagwa Mohammed Omer lives in the town of El Obeid in central Sudan. She received a *murabaha* loan in the amount of 550 euros in February 2007 repayable over a period of 18 months from the Savings and Social Development Bank who in conjunction with Islamic Relief jointly finance a microfinance programme aimed at women microentrepreneurs. Following a short period of training provided by Islamic Relief that focused on analysing the feasibility of business ventures and basic bookkeeping skills, Nagwa, a mother of four boys, invested the money in opening a small shop adjacent to her home. She stocked her shop with basic household grocery items that were bought and delivered to her by bank staff. She favoured this business idea because it allowed her the opportunity to earn an income without having to leave her home. Nagwa manages to generate a profit of over 200 euros from her monthly sales and she finds no difficulty in meeting her monthly repayment of approximately 35 euros. Nagwa is proud to be able to own her own business and says, "I am becoming more economically self-sufficient and independent through my business, last month for the first ever time I managed to buy all the school needs for my children in one go before the school year began". Not only is the focus of Islamic Relief's microcredit programme on establishing small businesses and increasing women's incomes, but, as Nagwa testifies, it is about increasing women's self-esteem and restoring their dignity and independence through earning their own livelihood.

As the above examples intimate, microfinance programmes may face expansion problems and high administrative costs due to the additional efforts required from loan officers in locating, purchasing and re-selling goods to borrowers – it is not difficult when the number of loans is small but when there are hundreds of loans to be disbursed it becomes very time consuming for loan officers. Islamic Relief Pakistan employs specialist procurement officers and it is they, rather than loan officers, who are responsible for purchasing and delivering the financed items. Furthermore, this financing technology is also relatively expensive when there are potential borrowers, retail outlets for example, who wish to acquire a large number of small items (perhaps from various sources) with their loan. Due to the nature of the *murabaha* loans it is easier to finance the purchase of one large commodity rather than many small items. Interestingly, Islamic banks who use this financing technique tend to keep large inventories of property; cars and other products in demand by borrowers and they are actually hybrid institutions combing the functions of a bank and a trading company. Although, on a much more modest scale, there is certainly some scope for microfinance institutions to negotiate discounted prices from wholesalers and perhaps also consider holding stocks of frequently purchased items.

5.3 Mudaraba loans given by Islamic Relief

Islamic Relief's microfinance programme in Bosnia & Herzegovina has given a relatively small number of *mudaraba* loans. As outlined in chapter 2 in a *mudaraba* contract two parties are involved; the financier, who provides all the money and the entrepreneur who uses his or her skill to invest the money in an attractive business. Profits were shared between Islamic Relief and the entrepreneur according to pre-determined ratios. Had a loss occurred and providing it was not due to neglect or misconduct by the entrepreneur, then Islamic Relief would have lost its money, while the entrepreneur would merely have lost his or her time and effort. For this reason *mudaraba* contracts are relatively risky and require a great deal of confidence in the borrower. Islamic Relief Bosnia & Herzegovina has only given *mudaraba* loans to those borrowers who have in the past received and successfully repaid at least one, but more often two, general business loans. They have, thus, already demonstrated their honesty and entrepreneurial capacity, and whilst this is not always a guarantee for future conduct and capacity it at least provides us with a good indication of future behaviour.

Before engaging in *mudaraba* or *musharaka* type ventures it is necessary to clarify the legality of providing loans generating profit for both parties. Thus, in Bosnia and Herzegovina and Kosovo it is not normally possible for an NGO or registered microfinance organisation to provide loans in which the rate of return is not known at the outset and for which "profit" is generated. With legal assistance Islamic Relief has circumvented the latter obstacle by stipulating to the local regulatory authorities that all profits generated and received from such loans are ploughed back into our microfinance programmes and used to extend further business and housing loans. In contrast, in Sudan and Pakistan, where Islamic financing is widespread even among commercial banks, Islamic Relief's microfinance programmes have not faced such difficulties.

It is worth stressing that partnership loans generally also require loan officers to expend much more time and effort in investigating the feasibility of the loan proposal as well as providing

expert assistance and monitoring loan use. It is only feasible for one loan officer to have perhaps a handful of such loans in his or her portfolio at any one time. However, at the same time they offer the possibility of generating greater returns to both parties. Thus, in the example given below the profit generated was equivalent to 40 times the income received from a normal housing or business loan. The case study in Box 2 describes a *mudaraba* loan that Islamic Relief undertook in Bosnia & Herzegovina.

Box 2 – Mudaraba financing

Nurudin Alihodza lives in Travnik in central Bosnia & Herzegovina. He is married with 5 children and is a soldier in the Bosnian Army. In 2001 he received a housing loan of 2,000 euros from Islamic Relief's microcredit programme for repairs to his house that was badly damaged during the war. He was prompt with his repayments and repaid his loan completely in 2002. At this stage Nurudin expressed his interest in receiving a *mudaraba* loan from Islamic Relief. Since he had repaid his first loan without difficulties, had a good joint venture business proposal that was fully investigated by the relevant loan officer, as well as a reputation within his community of being an honest and hardworking man, Islamic Relief agreed with his proposition. Islamic Relief bought 5 pregnant heifers that cost 5,000 euros and delivered them to Nurudin. He already possessed a relatively large stable as well as approximately 100 acres of land on which to graze the animals. Nurudin and Islamic Relief agreed to divide all profits from the venture with 90% of profits generated from selling milk and calves going to Islamic Relief while Nurudin would receive just 10% of the profits but would keep the 5 cows. Islamic Relief and Nurudin signed an agreement to this effect stipulating the percentages according to which the profits would be divided; when the profits would be divided; and the length of the agreement. At the end of the agreed period Islamic Relief received 5,895 euros while Nurudin received just 655 euros in cash but kept the cows valued at 5,000 euros and which by this time had also produced several calves.

5.4 Qard hasan loans given by Islamic Relief

Islamic Relief's microfinance programmes in Pakistan and Sudan predominantly advance *murabaha* loans. In comparison, while the microfinance programmes in Bosnia & Herzegovina and Kosovo have given a significant number of *mudaraba* and in particular *murabaha* loans, the majority of the loans they give can be classified as *qard hasan* loans. In Bosnia & Herzegovina all loans are given in cash either at Islamic Relief's offices or with local loan coordinators in the field whereas in Kosovo borrowers are issued with a loan confirmation receipt which they can then present at a local bank to receive their loan in cash. In this type of loan Islamic Relief charges a flat fee to cover for administrative costs incurred in disbursing the loan. Thus, in Bosnia & Herzegovina the administrative fee is 38 euros for a loan of 12 months and 50 euros for a loan of 24 months duration. This is a fixed fee and is

charged regardless of the size of the loan. In Kosovo only loans for 12 months duration are given and the administrative charge is 50 euros. In both programmes the fee is an actual reflection of real administrative charges that Islamic Relief incurs in receiving, analysing and disbursing loans and does not vary with the loan amount.

While *mudaraba* and *murabaha*, and indeed other types of Islamic financing can be applied to extending microfinance in almost all instances, they are not always the least cost methods of extending microfinance and in practice would mean that only a relatively limited number of loans could be given. Furthermore, the margin that Islamic Relief, for example, would have to charge borrowers even to cover a small proportion of its costs would make the loans unattractive to poorer borrowers. Therefore, the use of a flat administrative charge has been adopted in Islamic Relief's microfinance programmes in Bosnia & Herzegovina and Kosovo and indeed this loan methodology works well. Presently, the microfinance programmes in Bosnia & Herzegovina and in Kosovo employ a range of loan methodologies that depend upon the purposes for which the loan is used – in contrast Islamic Relief's microfinance programmes in Pakistan and Sudan use only *murabaha* financing. The following two examples show business and housing loans that Islamic Relief has given using the *qard hasan* methodology.

Box 3 – Qard hasan business loan

Hala Deliu lives in the village of Rezalle in the Municipality of Skenderaj in Kosovo. She has 6 children, the youngest is 5 years old and the eldest is 23. Before the war her husband was the only one providing an income for the family. Her husband was killed during the war, and Hala was left with the responsibility of both bringing up her children alone and also earning an income. With little chance of securing paid employment anywhere she decided to open a small grocers shop from home. With her own savings she paid for some shelves to be constructed and put them up in one room in her house. However, having exhausted her savings she had no money left to stock the shop with items to sell. She was reluctant to approach a bank for a loan since they charged a high interest rate on their loans and also asked for the deeds to her property as collateral. She then heard that Islamic Relief had recently begun a microcredit programme in the region and was providing small business loans for microentrepreneurs, especially women. She approached Islamic Relief and applied for a loan. She had never received a loan before in her life and although administering a shop was a new venture for her, Islamic Relief's microcredit organisation START decided to take a risk and approve her a loan of 1,000 euros in 2002. She used the loan to stock her shop with basic foodstuffs and household items. Throughout the duration of her loan she was always prompt and on time with her repayments and successfully repaid all instalments after 12 months. She was able to generate an income 450 euros a month from her shop while the monthly loan repayments were only 84 euros. She received a second loan of 1,500 euros in 2003 that she invested partly in her shop and also used to buy machinery to plough land near her house. One again she was on time with all repayments and by the end of 2004 had repaid her loan completely. During this time her shop has grown and now stocks a range of food and retail items. She has also managed to buy a small generator that she uses to provide electricity for her home and shop when there are power shortages. At the beginning of 2005 Hala received a third loan of 2,000 euros from Islamic Relief to continue expanding her business.

Box 4 – Qard hasan housing loan

Vezira Demir is from the village of Duhici in Visegrad Municipality in south-eastern Bosnia & Herzegovina. At the outbreak of the Bosnian War in 1992 Serb forces occupied her village and her husband was arrested and then killed. Her house in Duhici was completely destroyed with explosives. She escaped with her 2 children to the town of Visoko and lived in a collective centre with other refugees until 1996. In 1997 Vezira moved to Sarajevo and into an empty apartment owned by a Serb family where she lived for 16 months. She was then evicted as the original owners returned and lived in a succession of rented apartments until she decided to buy a small plot of land in an area of Sarajevo called Pofalici. She used all her savings and built a very basic one storey house, although she still could not move in because it lacked basic amenities. In 2002 she received a housing loan of 500 euros from Islamic Relief. This amount was just enough to make the house habitable. She stopped paying rent and immediately moved in. As soon as she had repaid the first loan Vezira asked and received a second loan of 750 euros in 2003. She used the second loan to install a permanent roof on her house. Having fully repaid her second loan she received a third loan in 2004 of 1000 euros. She has used this loan to install a bathroom and doors to her house. Vezira does not work in paid employment and she only receives orphan's one to one sponsorship monies from Islamic Relief and a widow's pension from the State. She would not have qualified to receive a loan from a bank or other commercial intermediary yet she has successfully managed to receive and fully repay 3 housing loans provided by Islamic Relief's microcredit programme and now lives in her own house. Once she has repaid her current loan she will ask Islamic Relief for a fourth loan to continue making improvements to her home.

It is worth remembering, and should be apparent from the above examples, that the size of microfinance varies according to local circumstances. What is considered microfinance in Bosnia & Herzegovina or Kosovo (loan amounts of around 1,000 euros) is a relatively large loan in lower income countries such as Sudan or Pakistan.

5.5 Potential negative impacts of microfinance

The case studies detailed in the preceding pages highlight examples of successful borrowers for whom loans have clearly had a positive impact. However, it should also be remembered that a loan is essentially an increase in debt and there exists the potential for significant negative impacts as well. After all, credit is a two-edged tool, and since credit is debt it can destroy as easily as it can build. Thus, for example, the patriarchal social structure in many countries may limit the extent to which women borrowers can actually benefit from loans. There is increasing evidence of microfinance leading to impoverishment, increased domestic conflict or abandonment of women borrowers (Rahman 2001). Particular interest has focused on the fact that registration of loans in women's names does not necessarily mean that women have control over loan use. In some cases women do not even participate in decisions about the loan application. Rather control and decision-making are both in the hands of husbands or other male relatives. Microfinance programmes that "target" women borrowers may actually be merely using women as unpaid debt collectors mediating between credit lending organizations and male family members and in the process increasing women's dependency on men and increasing the level of domestic conflict when men invest the loan monies poorly or fail to meet repayments. Credit and income generating programmes often frame the problem of poverty as one of a temporary and easily remedied cash-flow problem, rather than one of unequal social

relations and their institutionalization in broader economic policy. Some argue that microfinance programmes may even divert resources and/or the women's attention from other more effective strategies for empowerment (Johnson and Rogaly 1996).

5.6 Minimalist or credit-plus programmes?

Microfinance programmes that provide only loans are referred to as minimalist programmes while those that that incorporate elements of social intermediation such as technical assistance, group organisation and non formal education activities designed to raise borrower's social and economic awareness and strengthen their leadership abilities are often referred to as "credit-plus" programmes. Proponents of the latter argue that borrowers who would like to expand their enterprises or enter newer more dynamic fields face many constraints in addition to a lack of capital. Thus, microentrepreneurs may face lack of access to markets, low technology levels, be illiterate or semi-literate, and may lack training in business and related skills. It is argued, therefore, that credit is a necessary but not sufficient condition for them to enhance their business performance. Additional support such as training and technical assistance is needed to enhance their enterprises and productivity – indeed the addition of training components has been justified as a means of guaranteeing effective use of credit and improvements in productivity and income for borrowers, as well as being necessary to overcome a variety of non-financial barriers that borrowers may encounter.

In practice there can be difficulties when a single organisation attempts to operate a microfinance programme as well providing other services such as training. Microfinance institutions must aim for some sort of financial viability if they are to be of continuing benefit for their members and they must also enforce discipline upon poor borrowers. It can be difficult for an organisation and its staff to insist on such discipline while at the same time being sympathetic and supportive of the needs of borrowers. Furthermore, the provision of training components can often be extremely costly. Therefore, in practice many microfinance programmes are minimalist and limit themselves largely to the provision of loans. In some cases microfinance organisations do not wish to incorporate training assistance or follow up into their programmes because their underlying philosophy is that microfinance institutions do not know what is best for borrowers but rather that borrowers must decide for themselves how best to use their own money. Furthermore, they argue that training is not essential to borrower eligibility or repayment performance on a loan and tend to see such assistance as superfluous and outside the scope of their expertise. However, it is more difficult to use the distinction between minimalist and credit-plus microfinance programmes when describing *shariah* compliant programmes since such initiatives typically involve the sharing of risk, and may involve the provision of technical input in the loan financed venture by the financier, the sharing of profits and loss, etc. Islamic microfinance programmes intrinsically involve a greater level of interaction between financier and microentrepreneur.

This chapter has concentrated largely on explaining the financing technologies adopted by Islamic Relief's microfinance programmes in Bosnia & Herzegovina, Kosovo, Pakistan and Sudan with reference to specific examples. The next chapter addresses issues related to the selection of borrowers, in particular it provides guidelines to loan officers when considering applications.

6. Selecting borrowers

The objectives of a microfinance programme and the mission statement in particular should act as a first point of reference when considering loan applications. Thus, the first question to be considered when assessing any prospective loan application is, will disbursing this loan help to achieve our microfinance programme objectives?

6.1 Programme eligibility criteria

However, it is also apparent that a microfinance programme should establish and follow clear borrower selection criteria. Applications should only be taken from those persons who satisfy the selection criteria. It should also be apparent that the selection criteria must also be consistent with the microfinance programme objectives. Thus, if one of the stated programme objectives is the empowerment of women borrowers then clearly the selection criteria should not limit loans to men. By establishing and adhering to clear selection criteria we can ensure that those targeted are, in fact, reached and those who fall outside the selection criteria are excluded.

The following is a list of selection criteria that the business loans programme in Pakistan employs:

- Applicants may be male or female
- Applicants should be over 18 years of age
- Applicants should have been living in the programme target area for at least the previous two years.
- Applicants should not be involved in activities considered criminal or immoral.
- Applicants may be from any ethnic group.
- Applicant must have Nadra (Pakistani) identity card.
- Applicants should be those considered as “relatively poor” or from other vulnerable sectors of the population (such as widows, registered disabled, etc).
- Applicants should accept and abide by the terms and conditions of the loan.
- There should not be more than one loan held by a household at any one time.
- Applicants should possess relevant business and management skills

The housing loan programme in Bosnia & Herzegovina has the following criteria:

- Applicants may be male or female.
- Applicants should be over 18 years of age.
- Applicants must be citizens of Bosnia & Herzegovina.
- Applicants may be from any ethnic group.
- Applicants should have ownership of the house or property that they seek to repair or the land on which they wish to construct.
- The loan the applicant is seeking should enable the borrower upon completion of loan-financed investment to move into the reconstructed/repaired house.

- Applicants should be those considered as "relatively poor" or from other vulnerable sectors of the population (such as widows, registered disabled, etc).

Clearly, some of the criteria such as the age of the applicant and their gender is unambiguous and can be applied without difficulties. However, other criteria, such as who is poor, are more subjective and depend to an extent on the judgement of loan officers.

6.2 Guidelines for assessing loan applications

Although loan officers should have a certain amount of discretion in selecting prospective borrowers, there are a number of procedural measures and considerations that loan officers should consider when undertaking selection. The following is a list of some of these, although it is by no means exhaustive.

- Loan officers should analyse the technical, economic and social feasibility of the proposal as well as the extent to which the application matches the microfinance priorities of the organisation. They should investigate the applicant's past transactions with other financial intermediaries (this may include local banks or other NGOs) as well as his/her experience in the proposed project and reputation in the community. For the former, it is important to co-ordinate loan activities with other NGOs working in the target areas, through for example, trying to share lists of borrowers (and perhaps even more pertinent, those persons who have defaulted on their loans). For the latter it is important to liaise with the relevant local community organisations.

- Since Islamic finance involves sharing risk, as financiers and potential partners in the venture loan officers should try and find out much more information about a borrowers business than non-Islamic lenders would seek for lending against collateral or guarantees. This will include confirmation that funds are to be deployed in permissible activities as well as transparency in reporting financial information of the enterprise for which the money has been sought.

- Loan officers should have responsibility for completing all loan applications and eliciting all relevant information. There should be no lower limit on loan size. However, there should be an upper limit on all individual loans. By putting a ceiling on loan sizes you immediately discourage potentially richer borrowers from applying for loans. In any event, it should be assumed that the overwhelming majority of loans will be much lower than the upper limit. At the same time, in exceptional cases, this ceiling may be breached, especially for loans to group enterprises or businesses that can create new employment opportunities for several persons.

- At the outset microfinance programmes should try to work with ***existing*** economic activities no matter how small. Launching large new enterprises with a loan is more difficult and may require extensive inputs over several years before the business can become established. However, once a borrower has successfully repaid a loan, thereby demonstrating his/her integrity and trustworthiness, he/she may be considered for a loan for a new enterprise.

- In general, there should be no restriction as to the type of enterprise to be financed by the loan. Potential borrowers may undertake rural (including agricultural) or urban, seasonal or permanent, activities. However, loan officers should ensure that the purpose for which the loan is solicited is *halal* (they can never control **actual** loan use). Thus, for example, loans should not be given to someone who wants to open a liquor or gambling shop. Islamic microfinance organisations should also try to instigate some moral and ethical code into their work. For example, Islamic Relief's microfinance programme in Bosnia and Herzegovina decided that it did not want to authorise a loan to a farmer who wanted to rear poultry in small cages, because loan officers felt that it involved unnecessary cruelty and suffering to animals, even though such a venture was highly profitable.

- First time loans should focus initially on local markets. Efforts to find new markets are often costly and difficult. Again, once a borrower has successfully repaid he/she may be considered for a loan that produces for a new market. However, care should be taken to avoid providing loans for activities that will "saturate" the local market. In many cases, local markets are relatively small and will withstand only a small number of for example, carpenters, car mechanics, retail shops, etc.

- Initially, loans should be extended for working capital. Small short-term loans will not only test the borrower's commitment to repay but also allow a microentrepreneur to see whether his/her activity is indeed profitable and could grow with more capital. Indeed, a new borrower may lack experience managing debt and a large loan may actually bring business failure. Once the borrower successfully repays he/she may be considered for a loan that will be used to finance fixed capital investment over a longer period of time. Thus, Islamic Relief's microfinance programme in Bosnia & Herzegovina is disbursing an increasing number of two-year housing loans.

- It is worth bearing in mind that the larger the loan requested the greater the likelihood that it will be used by a "richer" microentrepreneur. The smaller the loan requested generally the poorer the borrower, remember the focus of most microfinance programmes should be to help **poor** microentrepreneurs. In any event, it is also highly likely that the "richer" microentrepreneur will be able to access loans from other sources such as banks. Therefore, loans should be, especially at the outset, for relatively small amounts.

- Efforts should be made to analyse the market the prospective borrower is working in, this will help loan officers to understand the environment in which borrowers' enterprises operate. Loan sizes should be matched to economic conditions. Loan payments should take into account not only expected income from the loan-financed enterprise, but also other sources of income (for example, regular salary income from fixed employment). Generally, urban loan cycles are shorter than rural cycles. At the beginning loan cycles should be limited to 12 months or less to reduce risk.

- Where possible, grace periods should be avoided; they are often unnecessary because they presume that the loan will be repaid from the loan financed activity. Most poor people have multiple sources of income, not just one. They can often make repayments from other sources

of income, not only the activity financed by the loan. Grace periods also increase the length of time it takes to repay the loan, tying up limited funds that could otherwise be used to extend further loans.

- Often the prospective borrower will provide information that he/she thinks will improve their chances of receiving a loan, care should be taken therefore of overly optimistic forecasts. The tendency of potential borrowers when providing information to loan officers is to overstate income and understate existing credit obligations or indebtedness. Try to analyse a proposal on the “worst possible scenario” outcome. Thus, even if the loan financed activity encounters difficulties, will the borrower be able to repay?

- A key policy decision any microfinance programme must make is determining what proportion of a typical borrower’s income should be earmarked for the regular repayments. As an approximate guide, loan officers should allow borrowers to use only one-third of their disposable monthly income towards monthly loan repayments. Most microfinance lenders will generally not accept a monthly debt burden that exceeds 40% of monthly disposable income and tend to favour instead monthly repayments of between 20-33% of net monthly disposable income.

- The lending organisation should try to target specific geographic regions, certain urban areas or collection of villages. This will make control and supervision easier and lower administration costs.

- In general, loan officers should allocate up to one hour for each interview, although most interviews should take no more than 30 minutes, and they should keep interviews relaxed and informal. Relaxed participants are more likely to provide the information you want, and care should taken to treat the potential borrower with sensitivity and respect. Appendices 3 and 4 contain the applications forms for business and housing loans used by Islamic Relief Bosnia & Herzegovina. Essentially the questions in the questionnaires are concerned with establishing an overall profile of the potential borrower through information on their demographic, socioeconomic and business characteristics as well as details on the effective and potential demand for loans, debt burden and repayment capacity. Loan officers should be realistic on how many interviews can be conducted within a given period of time – they should reduce the number of interviews if necessary and try and focus on eliciting quality information.

- Care should be exercised when asking about income, as this is a sensitive issue. Loan officers should choose an appropriate time and place where respondents can relax and interruptions can be minimised. Islamic Relief’s loan officers in Bosnia & Herzegovina, Kosovo and Pakistan generally visit the prospective borrower at his/her place of business to complete the application form, and do not ask borrowers to visit Islamic Relief’s offices. This enables them to familiarise themselves better with the borrower’s business and verify the information provided. Loan officers should not **make promises to borrowers**, rather they should clearly state that it is the Loan Approval Committee who will take the decision to approve or reject the loan In either event prospective borrowers should be informed relatively quickly of the final decision – certainly no more than a couple of days at most.

- Loan repayment schedules should be kept simple. Borrowers can better understand and loan officers will find it easier to administer loans with relatively equal repayments. However, in circumstances in which the activity will not produce immediate returns, consideration can be given to reducing the level of the initial repayments. In the latter case, once the activity does start producing returns the level of repayments should be increased and maintained through the remainder of the loan period. If borrowers have regular income from other sources such as pensions then it is better to adjust the timing of repayment schedule to take account of such income, for example, to make the repayment date the day after pensions are usually received.

- Borrowers should not be encouraged to hold two or more loans simultaneously from whatever source.

- Remember that not every microentrepreneur needs or should be encouraged to take a loan. The constraint to growth is not always a shortage of capital. It may be limited demand for the product, the microentrepreneur's lack of time or appropriate skills, scarcity of raw material, etc. The consequences of a loan (which is after all increased debt) in these circumstances could be disastrous. A loan can often do more harm than good.

- The success or failure of the programme may depend to a large degree upon the professionalism of the frontline programme staff and in particular loan officers. They must maintain high levels of conduct and integrity. Thus, under no circumstances should they accept gifts and or money no matter how large or small they may be. Indeed, there is a relevant *hadiths*: Anas ibn Malik reported that the Prophet, peace be upon him, said, "When one of you grants a loan, and the borrower offers him a dish, he should not accept it; and if the borrower offers a ride on an animal, he should not ride, unless the two of them have been previously accustomed to exchanging such favours mutually." (Al-Bayhaqi). Anas ibn Malik also reported that the Prophet, peace be upon him said, "If a man extends a loan to someone he should not accept a gift" (Bukhari).

- Islamic Relief's microfinance programme in Bosnia & Herzegovina has found it helpful to work with the assistance of local loan co-ordinators. Such persons help loan officers to "screen" potential applicants. This means that because they have better local knowledge of the community they live in, and they can help to identify which applicant is honest, trustworthy, likely to invest the loan wisely and repay his/her loan on time. Often they can also assist with collecting repayments. However, at the same time microfinance programmes should bear in mind that working through local loan co-ordinators can also bring difficulties. For example, loan co-ordinators might be under pressure to put forward applications from friends and relatives. It is generally better not to pay the local loan co-ordinators a salary, apart from reimbursing any travel expenses, or to include them among those selected to receive "first round" loans. Loan co-ordinators should possess the right motives and be more concerned with bringing benefit to their local community through access to loans as the following case study illustrates.

Box 5 – Local loan coordinators

Haji Samir Rahman is Islamic Relief’s loan co-ordinator in the town of Ustikolina in south-eastern Bosnia and Herzegovina. Haji Samir owns a small café in the town and has a reputation for being trustworthy and helping the community. Ustikolina is located some two hours drive from Islamic Relief’s offices in the capital Sarajevo. Islamic Relief receives a large number of applications for loans from Ustikolina. Through his local knowledge Haji Samir advises Islamic Relief on the reputation and enterprises of most applicants. Islamic Relief has disbursed hundreds of loans in the town of Ustikolina as well as surrounding villages during recent years and has near 100% repayment. All loans are distributed from Haji Samir’s café. New applicants can collect paperwork that needs to be completed from Haji Samir. Borrowers can also leave their monthly repayments with him; these are then collected by Islamic Relief’s loan officer responsible for the region during one of his bi-monthly visits. Without Haji Samir’s assistance the administrative costs of lending to geographically isolated and largely unknown borrowers in Ustikolina would be prohibitive. Islamic Relief does not pay Haji Samir, but he does draw satisfaction from helping people in his community to receive loans and develop their economic activities, at the same time he has gained a certain level of prestige as being Islamic Relief's loan coordinator and assisting the community.

6.3 Housing Loans

Islamic Relief’s microfinance programmes provide housing as well as business loans. Most low or moderate income families would probably be interested in housing loans that they can use to purchase or substantially improve their homes. Indeed along with the need for food, shelter is the most fundamental human need. It can also represent a major capital asset for poor families. However, the purchase of new homes, parcels of land upon which to build, or major upgrading of a current residence often represent sums of money that require relatively long loan terms to keep repayments within the reach of poor families. Microfinance programmes can, nevertheless, be adapted quite easily to incorporate housing loans. A series of relatively small repeat loans over periods of between 1-4 years for example, can allow poor households over time to finance a succession of home improvements. This mirrors the normal process most families go through in building their homes incrementally. They may begin by first buying (or simply invading) land, building a core house and then gradually improving the structure by increasing its size and adding amenities such as sanitation connections as funding becomes available over a period of several years. **Poor families must build their homes progressively in order to be able to afford them**.

Traditional mortgage based housing loans require fixed payments over long periods of time, a stable and verifiable source of income, a credit history, and full legal title to the property. Poor households often have difficulties meeting some or all of these requirements. Many have fluctuating incomes from informal sector employment, few have any formal credit record, and many may have only paralegal titles to the land. Furthermore, for many poor households in low-income countries the uncertainty of factors such as disease, unemployment and fluctuating income make such loans highly dangerous. If the household encounters difficulties

they risk losing their most precious asset, their home, which is a refuge from instability and old age. In contrast, poor households can generally plan and commit to the short-term payments in micro loans. Indeed their demand is usually for relatively small and short-term financing for incremental building or home improvements.

Occasionally it is asserted that loans for business are "economic" while loans for "housing" are described as social and that lending for housing does not contribute to economic development. However, as Daphnis & Ferguson (2004) point out loans for both microenterprise and housing are both strongly economic with important social components. Indeed, housing and not microenterprise represent the main means by which households in industrialised countries accumulate wealth. The housing industry usually accounts for between 15-20% of gross domestic product in most countries, it can employ substantial numbers of semi-skilled workers and is frequently the sector that catalyses economic expansion.

Islamic Relief microfinance initiatives in both Bosnia and Herzegovina and in Kosovo, and more recently in Pakistan, initiated housing loan programmes in response to demand from borrowers. In these programmes loans are given for the repair and reconstruction of war damaged homes to mainly female-headed households. Borrowers generally have relatively low, but stable, levels of income. Importantly, housing loan borrowers can also be salaried workers not only self-employed entrepreneurs who tend to form the majority of business loan borrowers. For housing loans loan officers should consider a number of extra factors. All potential borrowers should have a regular and stable source of income from which to repay the loan. Although new income may not be generated by directly by the loan, we should remember that at the same time funds may be released because rent, for example, will no longer be paid by the borrower. Furthermore, since many poor people operate their businesses from home, there may be a clear link between loans for improved housing and increased productivity and increased income for home-based entrepreneurs.

6.4 Consumption loans

Microfinance need not and indeed should not be confined to being used solely for income-generating activities. Very poor people need to satisfy their survival needs before they can invest in "income-generating projects". In any event, consumption expenditure on items such as health care, schooling, clothing and house repair is often very productive indeed. For example, money for medical treatment may enable a sick family member to return to work and earn money, or money for school fees will enable children to secure higher paid employment in the future. Many programmes have shown that loans for consumption purposes are popular – and therefore respond to a real need of the poor – and also that they are viable in financial terms. Consumption loans, by reducing the vulnerability of poor people, provide them with security. Poor people are constantly vulnerable to unexpected events such as illnesses and consequent medical expenditures, death and funeral expenses, etc. Consumption loans can assist the poor in coping with such events without the need to sell what few assets they may possess to meet unexpected expenditure. It is clear that most borrowers in Islamic Relief's microfinance programmes do use some proportion of their business or housing loans to directly satisfy their consumption needs. Our general policy is not to encourage or discourage this. Furthermore, in a departure from the traditional focus of loans for explicitly business

purposes, Islamic Relief's SSED microfinance programme in Pakistan also provides education loans to assist families with the costs of schooling.

7. Disbursing loans and receiving repayments

This chapter examines some of the practical issues associated with deciding in where a microfinance programme should work, how to approve and reject proposals, how loans should be disbursed, and what should be done when borrowers fall behind with repayments.

7.1 Where to work?

In all countries where Islamic Relief promotes microfinance programmes there are clearly defined geographical areas where the organisation operates. Applications from outside these regions are not received. These areas are selected after a process of consultation with local and regional governmental authorities and other relevant organisations working in the field such as the different United Nations bodies and other NGOs and microfinance organisations. The programmes attempt to prioritise firstly those regions that have larger numbers of poor people or returnees, secondly areas that are ignored by other NGOs and formal financial intermediaries such as banks, and thirdly those areas that are located within reasonable daily travelling distances from Islamic Relief's offices.

Local community or municipality representatives are then approached to assist in the process of presenting the terms and conditions of Islamic Relief's microfinance programmes within specific communities. If such representatives are found to be honest and express a genuine desire to assist their communities they are often asked to become local loan coordinators and assist in the process of identifying good applicants, disbursing loan documents for completion and collecting repayments.

7.2 How to whether to approve or reject a loan?

Loan officers should follow established guidelines in selecting prospective borrowers. Completed applications that meet the selection criteria should then be discussed at regular Loans Approval Committee meetings. Islamic Relief's committee consists of the microfinance programme coordinator, the loan officer responsible for the application and 2 other loan officers. At the approval committee meeting the loan officer responsible presents the application and it is analysed by those present. At this stage it the application is approved, rejected or referred for further investigation.

If it is approved, usually by consensus, then the borrower is immediately informed and asked to visit Islamic Relief's offices (or the local loan coordinator) to collect and complete the necessary accompanying loan documents such as guarantor's forms and a date is fixed for disbursement. Providing the borrower completes the necessary accompanying documentation the loan is disbursed on time as agreed. If the documentation is not fully complete then loan disbursement is postponed until such time as complete documentation is presented.

If the application is rejected the applicant is immediately informed and a brief explanation given. This does not, however, preclude the applicant making a future application. Occasionally, the committee is unsure what decision to take, perhaps due to a lack of information, and may ask for the relevant loan officer to undertake further investigations of

the loan proposal. Once the results of these investigations are to hand the matter is brought once again to the loans approval committee for further consideration.

For those loans that are approved:

- Loans should be extended loans quickly. Loan applicants will become discouraged if they have to wait weeks before receiving credit. This is even more important when the borrower is undertaking seasonal activities, as failure to deliver a loan on time may mean that the borrower will lose his/her opportunity to invest the loan in a timely manner.
- Make clear from the beginning that a loan is being given, not a donation, and if need be legal measures will be used to enforce repayment.
- The borrower should be made aware that he/she will have access to larger second (third, fourth, etc) loans based on successful repayment of the first loan. (This is not entirely uncontroversial, since it could be argued that an institution that focuses its efforts on repeat loans may help a smaller number of people to become less poor, but will not reach out to a larger number of people who may need smaller initial loans. However, at the same time it should be considered that growing businesses are successful businesses and if they are refused finance then the microfinance programme may only be left with the worse or more risky borrowers).
- Try to deliver the loan in the company of the local loan co-ordinator.

7.3 Where should the loan be disbursed?

Where the loan is disbursed and who should be present when it is disbursed depends largely on the type of loan that is given. Thus, *murabaha* loans, and this includes the majority of loans disbursed in Pakistan and Sudan, are typically delivered to borrowers' business premises. In contrast, for *qard hasan* loans in Kosovo borrowers are given a confirmation of loan receipt that they then present at a local bank located a few minutes walk from Islamic Relief's offices and receive the loan amount in cash. In Bosnia & Herzegovina approximately one third of all loans are disbursed by the microfinance programme accountant at Islamic Relief's main office. However, for those borrowers who live over one hour's drive away from Islamic Relief's offices the loan is disbursed by two loan officers in the presence of the local loan coordinator usually at the latter's place of work.

7.4 Should borrowers be reminded when repayments are due?

The loan agreement should clearly state the dates that repayments are due. However, the reason that some borrowers fail to repay on time is that they simply forget. Therefore, in Islamic Relief's microfinance programmes it has become standard practice to telephone beneficiaries (or contact them through the telephone numbers of neighbours or relatives) to remind them the day before that repayment is due. This is a relatively simple task and is usually done by the administrative assistant, secretary or even loan officer and although time consuming it is a relatively low cost and effective method of ensuring prompt repayment.

However, not all communities have a telephone. In such circumstances the loan coordinator who is generally resident in the local community can play an important role in reminding borrowers of repayment dates or even collecting instalments. His or her task is made easier if within each community there are regular repayments dates, thus, for example, the first

Monday of each month so that borrowers are instinctively aware of when repayments are due even without referring to their loan agreements.

Islamic Relief microfinance programmes generally offer various repayment options to borrowers:

- They may make repayments directly to loan officers on regular visits to the field. However, while this is accepted and causes few problems in Bosnia & Herzegovina, in Kosovo by contrast it is a last resort and not encouraged since security is a concern and loan officers are reluctant to carry significant amounts of cash on their person when travelling in the field.
- They may make repayments directly at Islamic Relief's offices during normal working hours (borrowers occasionally also send relatives such as husbands or wives or elder children to make repayments on their behalf).
- They may leave their repayments with recognised loan coordinators in their own communities (see Box 5, for example).
- They may make repayments at nominated banks and post offices where Islamic Relief holds accounts.

It may be that in other environments there are alternative repayment options. Obviously such alternatives should be explored as it is extremely important to facilitate repayment for borrowers otherwise the microfinance programme's service becomes unattractive.

7.5 What should be done when borrowers fail to repay on time?

A more difficult situation arises when a borrower is unable or unwilling to repay on time. This can cause particular difficulties since there are usually no penalties for late repayment in Islamic financing. However, the maintenance of repayment discipline and the creation of a credit culture are crucial to the sustainability of any microfinance programme. If wilful default is allowed without any sanction being applied then the reputation of the microfinance institution may be damaged and the whole programme collapse.

In Islamic Relief's microfinance programmes those borrowers who do not repay on time are usually contacted the following day either by a loan officer or loan coordinator and asked why they have not made their instalment. The vast majority of borrowers who fail to repay their instalments on the agreed date usually do so within a few days. The risk of public embarrassment in front of their neighbours if they wilfully default or the threat of legal action will ensure that most borrowers are prompt with their repayments.

If the borrower is genuinely unable to meet his or her repayments due to circumstances unforeseen at the time they received their loan then an *Islamic* financing programme has an obligation either to wait until such time as the loan can be repaid, re-schedule the loan repayments or simply forgive the remainder of the loan. Indeed the Quran states:

> *"If the debtor is in difficulty, grant him time till it is easy for him to repay" (2:280)*

The word "credit" actually comes from the Latin verb "*credere*" which means "to believe". Whoever gives credit to someone else should believe in that person, trust them, and believe in their capacity, responsibility and honesty. The introduction of guarantees, which is one of the principal difficulties that poor people face in obtaining a loan, shows that today credit has little to do with trust and more to do with business. Islamic Relief's microfinance programmes **believe** in the borrower and in many instances the guarantees it requires are not "real" in the sense that they can be used to recover the loan quickly. Should the borrower wilfully default the organisation can initiate legal proceedings to recover the monies loaned. However, the legal process can take several years before the court reaches a verdict and even if judgement is in favour of the microfinance programme it can take several years more for the court to actually implement the decision (this is, for example, the reality in Bosnia & Herzegovina). The programmes do, to a large extent, therefore trust the borrower.

Nevertheless, in cases in which it is established (usually after discussions with the local loan coordinator and a visit by the loan officer responsible) that the borrower is unwilling, rather than unable, to make further repayments then the microfinance programme should consider how best to proceed and recover its loan. With regard to its microfinance programmes and as a first step Islamic Relief's lawyers write a letter to the borrower reminding him or her of their obligations signed in the loan agreement. At the same time, since it is usually Islamic Relief's policy not to advance new loans in a community if existing borrowers are unwilling to repay their instalments, the loan coordinator, other borrowers and especially potential new borrowers also tend to exert peer pressure on anyone who is unwilling to repay.

If these measures fail to succeed then the borrower's guarantor(s) are contacted and asked to repay on the borrowers behalf. All loans advanced by Islamic Relief require borrowers to provide at least one guarantor who will be held responsible for repayment should the borrower fail to repay. In Kosovo each guarantor's statement authorises Islamic Relief to approach the guarantor's employer and deduct an amount equivalent to the debt owed by the borrower directly from the guarantor's salary. As a last resort, if guarantors are unable to repay, formal legal proceedings can be instigated against unwilling borrowers. In Bosnia & Herzegovina legal proceedings have only been brought against just five borrowers in the period 2001-06, that is just 0.001 % of the total number of borrowers during this period. In Pakistan, the microfinance programme has never resorted to legal redress.

7.6 How many loans should each loan officer have?

Budgetary considerations will dictate the total number of loans that can be distributed. The number of loans that any loan officer can have outstanding at any given time will vary between regions depending on various factors such as the proximity of borrowers and the type of lending methodology employed. For example, a higher number of loans can be given where a microfinance programme chooses to work with borrowers who live in urban areas, in close proximity not only to each other but also to the programme's offices that they can visit to make repayments, and for which the type of loan invested activity is relatively straightforward. However, in cases where the borrowers reside in relatively isolated rural villages some distance away not only from each other but also from the organisation's offices, whom loan officers must visit to collect repayments, and when loans are given for activities

which require significant analysis from loan officers, then the number of loans per loan officer will obviously be much less.

The microfinance programme in Bosnia & Herzegovina employs 8 loan officers and has around 1,500 loans outstanding at any one time while the microfinance programme in Kosovo employs 7 loan officers and has around 1,200 loans outstanding at any one time. In Bosnia & Herzegovina those loan officers that work in predominantly rural locations situated between one and two hours drive from Islamic Relief’s offices generally have between 125-130 loans outstanding at any one time. Those loan officers who work in a mixture of urban and semi rural locations situated less than one hour from Islamic Relief’s main office generally have between 140-145 loans outstanding at any one time. In the former cases, loan officers must themselves visit borrowers to collect repayments while in the latter borrowers visit Islamic Relief’s main office in Sarajevo to make repayments. In Kosovo Islamic Relief’s work is confined to 3 municipalities and the loan officers have specific delineated areas within this region. However, in contrast to Bosnia & Herzegovina the terrain is more difficult and travel is more time consuming, consequently loan officers generally manage around 100 loans each. In contrast to the above programmes, the SSED programme in Pakistan confines its activities to densely populated and specific urban neighbourhoods in the city of Rawalpindi. All borrowers are in close proximity, often within walking distance, of Islamic Relief’s offices. As a consequence, loan officers are able to administer a greater number, around 150-160 loans, each. Repayments in all programmes are monthly.

7.7 Should loans be given to men or women?

Experiences throughout the world, and Islamic Relief’s own programmes are no exception, have shown that women prove to be more committed and reliable borrowers than men. The practical lesson of this is that microfinance programmes should concentrate on women. Another reason to focus on women is that they generally form the poorest segments of the population. Microfinance programmes have also been shown to contribute significantly to women’s empowerment and it is also the case that there is a strong correlation between improving women’s welfare and improving the welfare of other vulnerable members of the household, such as children. However, this does not mean that the focus should be exclusively on women. A policy of focusing exclusively upon women borrowers may increase tensions in the household or in the wider community. Furthermore, poverty may often affect women more than men, but it is not exclusive to them. Thus, and in contrast to many other microfinance institutions that focus exclusively upon women, Islamic Relief gives loans to **both** men and women.

8. Monitoring, evaluating and assessing the impact of microfinance programmes

This penultimate chapter examines issues related to the monitoring and evaluation of microfinance programmes. It looks at issues such as appropriate computer software to monitor financial performance and the financial sustainability of the microfinance institution itself. Monitoring refers to the regular, systematic and on-going collection of timely and appropriate information that allows judgements to be made regarding the efficacy of work and it can also allow decisions to be made regarding improving the quality of service. Particular attention is given in this section as to how the impact of the microfinance programmes can be assessed.

8.1 What computer software should be used?

Accurate and detailed financial information regarding the performance of a microfinance programme can be generated relatively easily through installing an appropriate computer software package. Such a system should be able to provide an immediate financial update on each and every loan, including such information as when repayments are due, late repayments, outstanding balances, etc. Usually computer programmers are able to tailor computer packages to meet our specific needs. However, if a custom built software package is installed rather than one "off the shelf" it means that the programme is dependent to a certain extent upon the computer specialist it has commissioned. Consideration should be given to the potential size of the loan programme before deciding on the level of detail required. It is not sensible to spend excessively on computer software if at any one time the programme is only likely to have, for example, only a few hundred loans outstanding.

Islamic Relief's microfinance programme in Kosovo uses off the shelf computer software, namely the *QuickBooks* accounting package, while the microfinance programme in Bosnia & Herzegovina uses tailor made computer software created by a specialist programmer who has worked with various microfinance organisations. The latter system provides information on a range of financial indicators: the number and amount of loans according to loan officers, gender of the borrower, location, professed use, amount repaid, amount outstanding etc. It allows the organisation to analyse the patterns and trends in performance – especially the ability to examine the relationship between different factors.

The microfinance programme in Kosovo must submit monthly financial reports to the Banking Authority of Kosovo (BPK) and must also obey certain criteria relating to the liquidity of the microfinance programme, classification of loans in default, etc (see Appendix 12 for details). This generates regular financial information that allows the programme to monitor the financial health of the microfinance programme. The BPK monitors the loan operations of all banks and microfinance institutions in Kosovo. Interestingly, according to the BPK Islamic Relief's microfinance programme has the highest repayment rate of among all credit institutions in Kosovo, despite the fact that it is working in the poorest region of Kosovo and among the poorest borrowers of that region to whom formal financial intermediaries such as banks are unwilling to lend. The computer software can also provide an insight into the financial sustainability of microfinance operations – an issue that will be addressed in the next section.

8.2 Programme sustainability

In order to continue to serve poor people in the long term and in particular if it wishes to expand and serve more people, a microfinance programme must be designed to achieve some degree of sustainability and in the long term eventually become financially sustainable. A microfinance programme may well begin with grants from donors. However, to reduce dependence upon donors for funding it should also encourage savings, of course the legal obstacles in many countries means that this is not always possible. Indeed for many poor people access to a secure place to save is usually more important than access to credit because, for example, their income may only come from selling crops 2-3 times a year whereas they have regular spending requirements or they are more vulnerable to events such as ill-health, drought and floods.

Of course, a microfinance institution conforming to Islamic principles cannot access credit lines from many conventional lending institutions as do many microfinance organisations that disburse interest based loans since such funding is generally also given on an interest basis. However, alternatives, which require further investigation, do exist. These could include m*udaraba* agreements with institutional investors, access to *zakat* funds or *wakf* bonds.

How can a microfinance institution calculate its level of financial self-sustainability? A simple calculation can give an indication of how far the total costs of a microfinance programme are being covered by the income earned:

> % of total costs covered by income generated = income earned during 12 months / total costs during 12 months x 100

Total costs should include all the costs associated with operating the microfinance programme such as staff salaries, fuel expenditure, etc. The eventual aim will be to achieve a figure of more than 100% that is to have the income earned by the programme covering all the costs. However, among the thousands of microfinance institutions worldwide there are very few that are genuinely profitable. Most were begun with welfare rather than profit motives in mind, with easy access to grants – indeed many poorly managed NGOs have entered the field of microfinance in order to access easy donor funds. Subsidies may play an important role in the start and initial growth of a microfinance institution, however, they can also cause damage by discouraging the growth of efficient and sustainable institutions. Subsidies also send a signal to the microfinance institution and borrowers alike that the government or donor funds are a form of charity, which discourages borrowers from repaying and institutions from increasing efficiency. Moreover, microfinance institutions cannot always depend upon donors as reliable, long-term sources of subsidised funding. As a consequence, in recent years most institutions are making considerable efforts to increase their financial sustainability.

Islamic Relief’s microfinance programmes have gradually increased their financial self-sustainability in each of the years since their inception. Income that is generated from charging administrative fees and profit enables them to cover approximately one half of all the microfinance programme’s operating costs. These include items such as staff salaries, vehicle

maintenance and fuel consumption. The aim is to become completely financially self-sustainable within the next 5 years largely through increasing the scale and efficiency of the programme. Undoubtedly, the microfinance programmes could achieve even greater financial sustainability through increasing the administrative fees they charge or the proportion of profits they receive. However, Islamic Relief's programmes have taken conscious decisions expressed in their mission statements to reduce poverty or contribute to the post-war return process. Increasing year-by-year sustainability is being achieved but it is not the overriding priority for either programme. Frequently the original mission can easily be lost or obscured as a microfinance institution grows. The dilemma facing many microfinance programmes is attempting to maintain a balance between increasing financial sustainability and maintaining the original mission statement.

8.3 How can the success or failure of microfinance programmes be measured?

The information on financial indicators generated through computer software packages and sustainability calculations can provide useful insights into measuring the relative success of a microfinance programme and in particular on the institutional health of the organisation. However, with financial indicators alone it is sometimes difficult to ascertain the impact of microfinance programmes upon the lives and businesses of borrowers.

This section addresses the issue of impact assessment. At the outset it is worth mentioning that there is an ongoing debate, more so among academics than practioners, on the issue of assessing impact (for a comprehensive discussion of the issues surrounding impact assessment and guidelines on how to plan and implement social performance research, see the excellent series of papers prepared by Imp-Act 2003-2005). It centres essentially on the question of attribution, that is, whether it is possible to demonstrate that a particular intervention (in this case the provision of loans or loans plus training) has led to a specific change in the businesses or households of borrowers. Thus, impact assessment studies, it is argued, "are fraught with methodological problems and the costs of doing them usually exceed any benefits they may provide" (Adams, reported in Simanowitz, 2004). It is proposed, therefore, that assessments should focus instead on easily verifiable financial indicators such as the number of loans given to women, the rate of repayment, the level of financial sustainability, etc. Let us briefly examine this perspective first.

Financial criteria such as repayment rates are useful indicators of the performance of a microfinance programme. Thus, we can generally assume that the purposes for which the loans are being used are in fact generating returns because the loans are being regularly repaid and borrowers are seeking repeat loans. This is one indication that the microfinance programmes are in fact successful. Other financial criteria, such as number of loans to female-headed households, loan size, the purposes for which the loan is ostensibly used, average loan size, number of loans per employee, etc, are also useful indicators of a programme's relative success. These indicators allow us to draw up a profile of borrowers in terms of gender, age, location, martial status and type of financed activity, which we can compare with our target group of borrowers for example. It is always useful to present a summary of financial performance that combines the indicators such as the above and value of loans outstanding, financial and operational sustainability, portfolio at risk, etc.

However, the above are not sufficient indicators as they tend to focus on the institutional health of the organisation rather than the health or well-being of the borrower. High repayment rates can be misleading, for example, when borrowers seeks funds from third party sources so that they can repay on time and thereby become further indebted. The numbers of loans given to women may hide the fact that husbands or other male relatives on occasions appropriate loans and invest badly or misuse the money leaving women borrowers with heavy repayment burdens. Microfinance providers should not, therefore, rely solely on such financial indicators to measure the performance of their programmes.

Furthermore, since the mission statement of many NGO microfinance programmes is to "alleviate poverty" (in recent years many programmes have explicitly linked their activities to contributing to one or more of the MDGs as well) by encouraging a process of transformation in the lives of borrowers and their communities, whether a programme contributes to alleviating poverty or not is ultimately the criterion by which the programme's success should be judged. Financial criteria alone cannot provide us with this insight. NGOs committed to alleviating poverty should have an interest in understanding how effective microfinance has been in lifting people out of poverty, and to compare the relative costs and benefits of using microfinance as a poverty alleviation tool with other poverty alleviation interventions. In addition, microfinance organisations require a better understanding of the ways in which borrowers utilise loans, the constraints they face, reasons for success or failure, etc. This information is directly relevant to operational design issues, and can assist in improving the services offered in a way that not only increases impact on borrowers but also improves the performance of the microfinance institution itself. Of course, ascertaining whether we are achieving our objectives is a difficult process since poverty includes social, psychological and political, as well as economic dimensions. Nevertheless, that is how organisations concerned with poverty alleviation should consider measuring their success: by whether or not poor people improve their lives through participation in their microfinance programmes. There is a need, therefore, to complement the information gathered through monitoring financial criteria with more in-depth qualitative impact assessment analysis that examines the changes in the lives and businesses of borrowers.

It may be useful at this stage to describe the impact assessment procedures adopted by Islamic Relief's microfinance programmes. Although these are not comprehensive assessments, they do generate information that allow each programme to examine whether it is meeting its objectives, they are inexpensive and they relatively easily to implement. The methods do not rely solely on one tool and combine quantitative and qualitative information. The quantitative data is obtained through examining financial indicators that provides an overview on borrowers' lives and livelihoods while the qualitative information obtained through in-depth interviews provides the opportunity to explore in detail particular borrowers' circumstances.

Loan officers routinely collect baseline information on a limited number of important financial and social indicators (age, gender, number of dependents, business activities, sources and level of income, household assets, expenditure patterns etc.) for each borrower as part of the loan application process and enter the data into a specially created software package. This data is

updated with each new loan application. Since some borrowers have received consecutive loans for a number of years this has provided longitudinal data that allows performance to be analysed over a period of time.

To gain further insight the programmes randomly select a smaller number of borrowers (including some who subsequently cease to receive loans) whose progress they follow in detail through regular bi-annual visits. Borrowers are encouraged to speak openly and discuss the effects that their participation has had on their lives, compare their situation with others, and make suggestions on how Islamic Relief can improve its services (see Appendix 11 for a list of typical questions). Over the course of several years loan officers have been able to document changes in borrowers' business and household as he/she has received loans. In many cases they have concluded that the progress has been substantial (please see boxes 3 and 4 above for example). This method of examining impact has several advantages, in particular it enables the microfinance institution to better understand why borrowers behave as they do and how the changes occur in their lives and businesses as well as examine changes in aspects such as self-esteem, self-confidence, gender and community relations.

On a regular basis a microfinance specialist should examine the data gathered on financial and social indicators as well as the in-depth borrower interviews to determine trends over time. The issues raised in the analysis should be further explored through open-ended focus group discussions with a selection of borrowers, community loan coordinators and microfinance programme staff. The analysis should attempt to answer four questions:

1. Who uses the programme's products and services, and who does the programme exclude?
2. How do borrowers use the services on offer?
3. Why and when do borrowers leave the programme or fail to fully utilise the available services?
4. What is the impact of the programme's products and services on borrowers?

Both programme staff and borrowers should be made aware that the information they collect and the opinions they give are taken into account – this way they are not only motivated to collect data but also feel valued. Indeed, through providing mechanisms for direct input from borrowers, local loan coordinators and community leaders the impact assessments ensure that programme activities are more accountable to the people whom they claim to assist.

It is important to point out that such qualitative impact assessment is not without difficulties. Borrowers' livelihoods and the communities in which they live are complex. They often have multiple sources of income, and the loans provided are fungible, that is, they are not necessarily used for the purposes for which they were requested. Changes in income, assets, or employment show that something is different in the lives of borrowers but they do not *prove* that access to the microfinance programme caused the change. Without measuring changes in the lives of people who did not receive loans (through the use of comparison groups) it is difficult to attribute impact specifically to the credit that has been provided and since assessment may take place at one point in time it has to rely on the often unreliable recall of

borrowers to determine their status prior to receiving loans. Furthermore, we should be careful not to overestimate the effect that receiving loans can have - many other factors, such as market opportunities, the general economic climate, a borrower’s health, etc. are often much more important factors in determining success than simple access to capital.

It is important to stress that impact assessment procedures should not overburden staff or borrowers with an excessive amount of studies and reporting - clearly, it is not possible to ask every question or investigate everything, especially for a relatively small microfinance organisation with a few hundred or even a couple of thousand borrowers. Furthermore, there can be difficulties in combining “normal” loan officer work and the demands created by impact assessment. Loan officers may consider impact assessment as being less important than other work such as, for example, receiving applications, disbursing loans and receiving applications. Since the impact assessment relates directly to their own work there is also the possibility that loan officers may emphasise positive impacts and ignore negative changes. Nevertheless, it is clear that when successfully implemented impact assessment can contribute greatly to the skills, capacity and, in particular, the awareness of local staff.

Finally, it is worth mentioning that the information gathered in impact assessment should actually be used to assist in making decisions on how to improve products, service or organisational structure – after all, if the information is not to be used it is not worth collecting in the first place.

9. Conclusion

Despite the increasing recognition of the role of microfinance as a key component in poverty alleviation, and the proliferation of institutions providing microfinance services to poor and disadvantaged sectors of the population, very little attention has been given to creating Islamic, or more correctly termed '*shariah* compliant', microfinance initiatives – even when working in largely Muslim environments. Nevertheless, anecdotal evidence suggests that the demand for microfinance services based on Islamic principles is tremendous – there are, after all, around 1.3 billion Muslims worldwide. Certainly we can surmise that many Muslims refrain from using financial services that do not adhere to Islamic financing principles for fear of breaching their religious beliefs – for example Islamic Relief's microfinance programme in Pakistan is unable to meet the huge demand from potential borrowers despite it's Islamic loans being twice as expensive as interest based alternatives offered by other NGOs working with the same target groups and in the same localities. It would be reasonable to suppose, therefore, that the growth and development of many Muslim owned small businesses is constrained as a result of the unavailability of Islamic financial services.

This aim of this investigation, therefore, has been to provide practical advice on how a microfinance programme based on Islamic financing principles can be established. It has provided numerous examples from Islamic Relief's own experiences in implementing relatively successful microfinance programmes in countries as diverse as Bosnia and Herzegovina, Kosovo, Pakistan and Sudan. It is hoped that this document may encourage the provision of microfinance services that conform to Islamic financing principles and eventually, of course, the use of these services by microentrepreneurs.

It is apparent that profit and loss sharing financing techniques such as *mudaraba* and *musharaka*, although they may yield high returns to both parties alike, require relatively more input from programme staff and may incur greater risk. It is, therefore, unlikely that a microfinance organisation can actually administer more than a relatively small number at any one time. In contrast, other financing mechanisms such as *qard hasan* and *murabaha* although generally less risky and less demanding in terms of technical input and expertise and despite the fact that greater numbers may be administered at any one time, generally offer lower returns and often barely cover the cost of their disbursement. Herein lies the dilemma, to promote financial sustainability or achieve significant scale and outreach?

In fact, it is likely that a mix of loan technologies will actually promote the financial sustainability of the microfinance organisation, ensure significant scale and outreach, as well as provide the most **appropriate** type of financing to microentrepreneurs – we should not always assume that all entrepreneurs actually desire or will necessarily benefit from the same type of financing mechanism. Thus, it is likely that a successful and sustainable Islamic microfinance programme will actually employ a variety of *shariah* compliant financing methods according to the type of activity financed and the economic status, ability and trustworthiness of potential borrowers. Thus, for first time relatively poor and inexperienced borrowers wishing to finance stable, yet low yielding, ventures a *qard hasan* loan may be the most appropriate. It may be proper to provide *murabaha* or *ijarah* loans to those borrowers

wishing to finance the purchase of machinery and equipment. For experienced entrepreneurs lacking only capital for their ventures *mudaraba* may be the most suitable financing mechanism. In more complex ventures that could benefit from both parties providing capital as well as technical and managerial input, it may be appropriate to promote a *musharaka* agreement. Other *shariah* compliant financing methods can also, of course, be utilised. It is reasonable to assume that in Islamic microfinance initiatives the financing institution has a much more active role in the success or otherwise of the enterprise compared to interest based microfinance programmes.

As the examples in this investigation have shown, although more challenging than interest based programmes in terms of their design and implementation, successful *shariah* compliant microfinance programmes are not only feasible but they may in fact also offer several other advantages. Thus, from Islamic Relief's own experiences, they appear to engender higher rates of economic growth – anecdotal evidence suggests that microentrepreneurs are willing to undertake more profitable ventures if risk is shared. Furthermore, the concept of profit and loss sharing is more likely to result in a more efficient and optimum allocation of resources. It is also likely that Islamic microfinance programmes build greater levels of trust and understanding between microfinance provider and microentrepreneur, because they are partners rather than service provider and client. This is invaluable when the objective is development in the wider sense or peace and reconciliation, rather than simply income and employment generation. Furthermore, Islamic finance seems to promote more ethical investment and business practices among microentrepreneurs. This is probably a result of the restrictions on financing *haram* (often destructive) activities and an emphasis on honesty, transparency, and fairness in financing contracts and practices. Indeed, Islamic finance shares many of the features of socially responsible finance.

As has been constantly stressed throughout this document there is no one unique microfinance model or method of delivery that should be promoted. Rather, each microfinance programme needs to be tailored specifically to meet complex local realities prevalent within each country or even different regions within a country, the needs of microentrepreneurs and the complexity and nature of ventures to be financed. Ultimately, simple, easy to use existing or new microfinancing techniques that conform to Islamic principles will evolve through experience and experimentation over a period of time. Imaginative and innovative research can accelerate this process. This investigation is merely a small step in this process, and through its many shortcomings it is hoped that it may encourage others to write something more profound.

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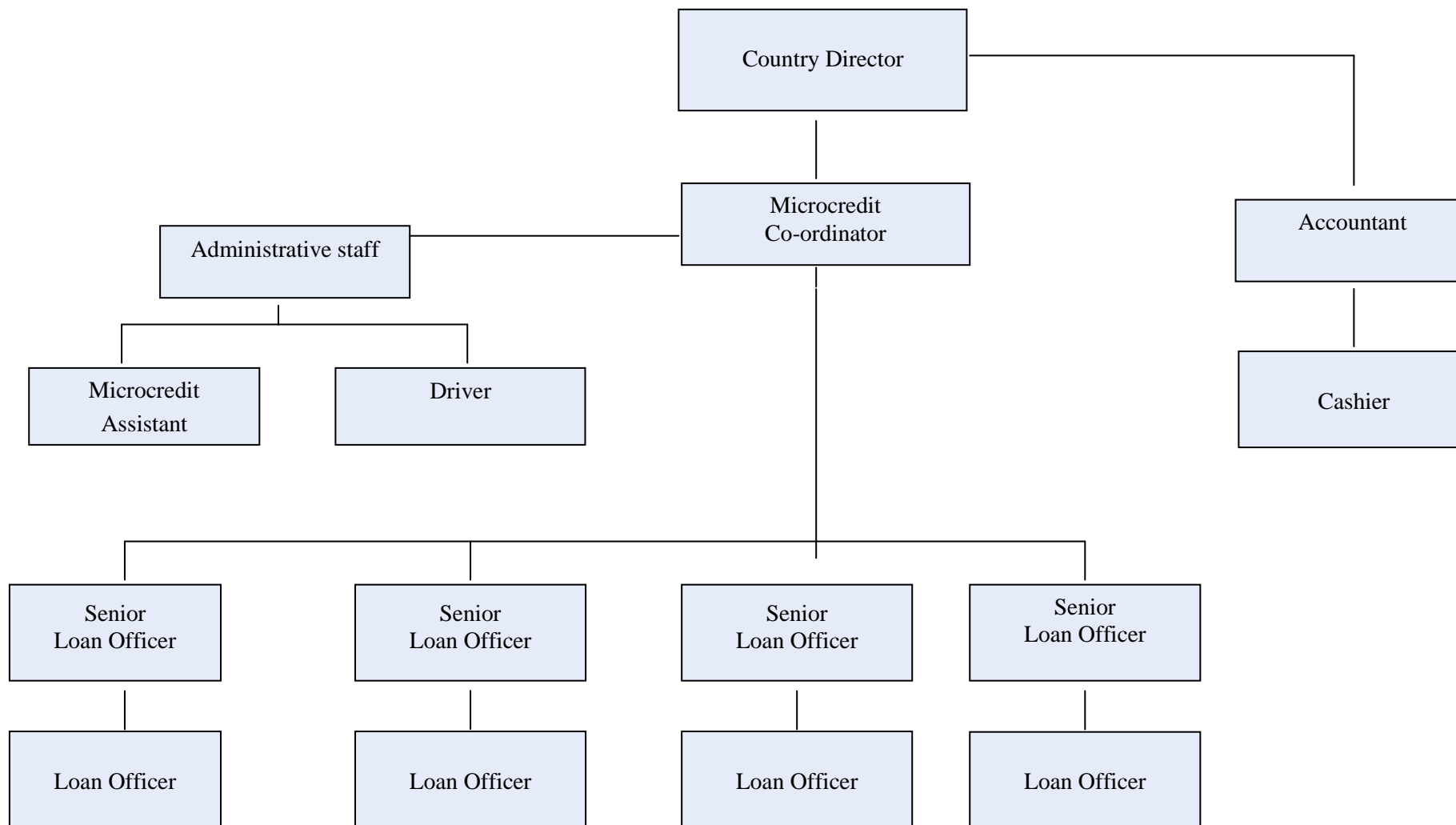
Appendix 1 – Generic Organogram of Islamic Relief's Microfinance Programmes

Appendix 2: Financial Landscape

At the time of writing, the average size of a *qard hasan* loan given by Islamic Relief in Bosnia & Herzegovina is around 1,282 euros for 12 months. An administrative fee of 38 euros is charged on such loans. Every year Islamic Relief BiH compares the cost of obtaining exactly such a loan in other microfinance organisations as well as commercial intermediaries such as private banks. The most recent results are shown below.

Name of Organisation	Status	Cost (euros)
Islamic Relief	Microfinance organisation	38
MI BOS PO	Microfinance organisation	240
EKI	Microfinance organisation	285
LOK	Microfinance organisation	256
Partner	Microfinance organisation	256
ALDI	Microfinance organisation	232
Melaha	Microfinance organisation	295
Prizma	Microfinance organisation	282
Lider	Microfinance organisation	208
PBS Sarajevo	Commercial Bank	87
Vakuf	Commercial Bank	89
Raifeissen	Commercial Bank	89
Gospodarska	Commercial Bank	89
Zagrebacka	Commercial Bank	88

As can be seen from the above the cost of obtaining loans from Islamic Relief is far cheaper than the comparable cost in obtaining loans from other microfinance organisations as well as commercial banks. Although Islamic Relief BiH could quite easily raise the administrative fee it charges on such loans so that it is near the levels charged by other finance providers, it has chosen not to do so. There are 2 principal reasons for this. Firstly, the administrative fee charged is actually a reflection of the administration costs (apart from staff salary costs in this case) that Islamic Relief incurs to disburse such loans. Secondly, since the fee is the same regardless of the size of the loan disbursed (the paperwork involved for a small loan is the same as the paperwork for a large loan) if Islamic Relief were to actually increase the fee (through incorporating staff salary costs) it would make it relatively more expensive for poorer borrowers who seek small loans to access our service. We do not, however, want to move away from our original mission statement of assisting poor microentrepreneurs.

Appendix 3: Business Loan Application Form

(Should be translated into local language)

To be completed by loan officer

A. Personal details

A1. Name ____

A2. ID Number ____

A3. Gender ____

A4. Civil Status ____

A5. Date of Birth ____

A6. Home Address ____

A7. Telephone number ____

A8. Family members living with you and for whom you are economically responsible (for children include ages)

No	Name	Relationship	Do they contribute to household income?
1			
2			
3			
4			
5			

A9. What are the sources of household income (how does the household sustain itself)?

____

____

A10. What is your profession?

____

B. Business details

B1. Is your business already operating or a new venture that will begin with the loan?

____

B2. Official name of business

____

B3. Business address

____

B4. Business telephone number

____

B5. Is your business registered?

____

B6. Type of business

____

B7. What are the main products or services provided?

____

B8. How many people work in the business? (Please list, includes salaries of employees, state if family members)

____

____

B9. Do you envisage that more people will be employed in your business within 12 months of receiving loan (explain why)?

____

B10. What machinery/equipment/land/livestock is already owned by the business?

____

B11. How long has the business been operational?

____

for applicants that are seeking funding for a new venture
B12. What is your previous experience in this field?

____

____

C. Business income and expenditure details
C1. What is your monthly business income?

____

C2. What is your monthly business expenditure?

____

C3. What is your monthly profit?

____

D. Previous loan experience
D1. Are you currently in receipt of a loan? (Please include details)

____

D2. Have you received a loan in the past? (Please include details, such as amount, period of loan, if successfully repaid, any problems with repayments)

____

D3. Have you received any assistance or donations within the last five years?

____

D4. When you need money for your business, from who do you usually borrow (please include terms and conditions)?

____

____

E. Loan proposal
E1. What is the amount of loan that you seeking?

____

E2. For how long are you seeking the loan?

____

E3. What is the purpose of your loan?

____

E4. Why do you think that your business will be successful?

____

E5. Where and to whom do you plan to sell your products and services?

____

____

E6. How much do you think you can repay each month?

____

E7. What type of guarantee are you able to offer:

a. Guarantors (individuals)
b. Guarantors (legal entities)
c. Property
d. Other collateral (please specify)

F. Other observations (please include any other information that you feel will be relevant to this application)

____

____

Loan officer responsible for completing application:

____

Signature of loan officer ____

Date of loan application ____

Loan decision ____

Signature of microfinance coordinator _____________________________________

Date of approval ____

Appendix 4: Housing Loan Application Form

(Should be translated into local language)

To be completed by loan officer

A. Personal details

A1. Name ____

A2. ID Number ____

A3. Gender ____

A4. Civil Status ____

A5. Date of Birth ____

A6. Home Address ____

A7. Telephone number ____

A8. Family members living with you and for whom you are economically responsible (for children include ages) ____

No	Name	Relationship	Do they contribute to household income
1			
2			
3			
4			
5			

A9. What are the sources of household income (how does the household sustain itself)?

____

____

B. Employment Details

B1. What is your profession?

____

B2. Where do you work?

____

B3. How long have you been employed there?

____

B4. What is your monthly salary?

____

B5. How long is your contract to continue working there?

____

C. Loan proposal

C1. What is the amount of loan that you seeking?

____

C2. For how long are you seeking the loan? ____

C3. What is the purpose of your loan? (for example, purchase of building material, payment to contractors)

____

____

C4. How much do you think you can repay each month?

____

D. Previous loan experience

D1. Are you currently in receipt of a loan? (Please include details)

____

D2. Have you received a loan in the past? (Please include details, such as amount, period of loan, if successfully repaid, any problems with repayments)

____

____

____

D3. Have you received any assistance or donations within the last five years?

____

E. Guarantee

E1. Are you the legal owner of the apartment/house where you wish to use the housing loan?

____

E2. What type of guarantee are you able to offer:

a. Guarantors (individuals)
b. Guarantors (legal entities)
c. Property

Other collateral (please specify)

____

F. Other observations (please include any other information that you feel will be relevant to this application)

____

____

Loan officer responsible for completing application:

____

Signature of loan officer____

Date of loan application____

Loan decision ____

Signature of microfinance coordinator _____________________________________

Date of approval ____

Appendix 5: Loan Agreement

(Should be translated into local language)

Signed on the _____ of ______ between:

1. Microfinance Organisation Mikro First Islamic Bosnia & Herzegovina represented by its director _______________ (hereinafter referred to as: Mikro First Islamic Bosnia & Herzegovina) and

2. ____________________ from the village of _______________, in the municipality of __________________ (Name and surname) who resides at settlement/street and No. _______________ hereafter referred to as: Loanee, ID No. ____________ and who possesses the Unique Personal ID Number ______________________.

Article 1.

A loan is approved in the amount of: ____________ **euros** /in words: __________________________. This loan will be repaid over a period of **12 months.**

Article 2.

In case of approving a loan for the purchase of goods or equipment on behalf of the Loanee, and after qualitative and quantitative receipt of the same, the Loanee has no right to any subsequent claims as to the condition or state of the goods or equipment provided. Evidence of receiving the goods is an integral part of this Agreement.

Article 3.

The Loanee is obliged to repay to Mikro First Islamic Bosnia & Herzegovina the total amount of ___________ **euros** according to the repayment schedule detailed below. Repayment of the loan will start from _________ and shall last ***12 months***. The loan will be repaid according to the following repayment schedule:

First repayment instalment on or before ______________ in the amount of _______
Second repayment instalment on or before ______________ in the amount of _______
Third repayment instalment on or before ______________ in the amount of _______
Fourth repayment instalment on or before ______________ in the amount of _______
Fifth repayment instalment on or before ______________ in the amount of _______
Sixth repayment instalment on or before ______________ in the amount of _______
Seventh repayment instalment on or before ______________ in the amount of _______
Eighth repayment instalment on or before ______________ in the amount of _______
Ninth repayment instalment on or before ______________ in the amount of _______
Tenth repayment instalment on or before ______________ in the amount of _______
Eleventh repayment instalment on or before ______________ in the amount of _______
Twelfth repayment instalment on or before ______________ in the amount of _______

The loan shall be repaid according to the above schedule. If repayment is made after the above mentioned dates, the loan will be considered as being in default. Repayments may be made at Mikro First Islamic Bosnia & Herzegovina offices in the cities of ________ or ________; or

directly to an authorised Mikro First Islamic Bosnia & Herzegovina Officer at a previously agreed time and place. Instalments will be made in cash, unless otherwise agreed.

Article 4.

In order to receive a loan, the loanee will provide a guarantee: a promissory note to repay the amount of the loan, acceptance of the loanee and signatures of two financially capable guarantors. If a primary debtor or guarantors are employed, they will provide an administrative ban on salary document in the event of non-repayment by loanee. In the event of Mikro First Islamic Bosnia & Herzegovina purchasing equipment or goods on behalf on the loanee, the loanee will provide a statement on purchasing and receiving the equipment.

Article 5.

If a repayment instalment is not made according to the timetable of repayments detailed in Article 3 of this Loan Agreement, the Loan Agreement will be considered cancelled and the rest of the loan is to be repaid immediately. In such a case, Mikro First Islamic Bosnia & Herzegovina has the authority to activate the Promissory Note as well as other guarantees, with the aim of recovering all loan debts.

Mikro First Islamic Bosnia & Herzegovina has the right to ask for repayment of the whole amount of the loan before the agreed deadline, in the following cases:

1. If the loanee transfers, destroys, or gives to a third party the equipment/machinery or products for which the loan is made or by selling, giving as present, or damaging the same.
2. If the loanee does not follow the agreements contained in this contract.
3. If it is subsequently discovered that the loanee did not give correct details regarding his/her loan application

Article 6.

Regulations that were valid during signing of this agreement will be valid for all other issues that are not mentioned in this Agreement.

Article 7.

This Agreement shall come into effect from the date of its signature.

Article 8.

All parties state that they have carefully read this Agreement and understood the meaning of all the provisions of this Agreement and are signing it to express their acceptance.

Article 9.

The Court of the city of __________ will be the nominated institution for resolving any possible legal disputes between the two parties.

Article 10.

This Agreement has 2 (two copies), 1 (one) being given to the loanee, and 1 (one) kept by the Lender.

LOANEE MIKRO First Islamic Bosnia & Herzegovina

DIRECTOR

________________________ ______________________

Address: ______________

____

ID No. ______________

Unique Personal Number ________________

Enclosed:

1. Proof on receiving the goods
2. A Promissory Note, certified and signed by issuer and guarantors
3. Statement on choice of the equipment

Appendix 6: Guarantor’s Statement

(Should be translated into local language)

____________________ ____________________
Surname (father's) name Unique personal number

_____________________ _____________________
Place of birth Home address and telephone

______________________ ______________________
Full name and address of employer Do you have an administrative ban?

____
The amount in KM of monthly repayment

I am stating that I as a guarantor, and if the main debtor ________________________ does not repay his/her loan to Mikro FIRST ISLAMIC Bosnia & Herzegovina according to Loan Agreement No: _______ in the amount of: _____________________ I shall repay the whole of the loan owing to Mikro FIRST ISLAMIC Bosnia & Herzegovina.

I will allow Mikro FIRST ISLAMIC Bosnia & Herzegovina to use this statement in the above mentioned case to deduct my salary from my employer until such time as the loan is completely repaid. This is in line with the Law on Executive Procedure.

______________________ ________________________
Place and date Guarantor's signature

_____________________ _______________________
Name of company - institution ID number and place of issuing

I am certifying the accuracy of this data and accepting the guarantor's statement.

____
Mikro FIRST ISLAMIC Bosnia & Herzegovina Officer

Appendix 7: Administrative Ban

(On a Guarantor)
(Should be translated into local language)

Number: ________________
Place: __________________
Date: __________________

1. An administrative ban is placed on the salary of the guarantor: ______________ with Unique Personal Number ____________________ ID No. _________ issued in _______________, residing in (place) ______________ street ______________ number ______ for **the purpose of proper repayment of the loan as the primary debtor** in accordance with Loan Agreement number _________________, signed by _________________________.
   (Name and surname of the primary debtor)
2. Repayment of the loan in the amount of ______________ (in words: _________________) will be implemented through an administrative ban in favour of the lender MIKRO **FIRST ISLAMIC Bosnia & Herzegovina** account number: ____________ call for number: __________________ account code: ______________ loan will be repaid in ________________ monthly rates with _____________________ per month (in words: ________________________) starting from ____________ until __________________ until such time as the loan has been completely repaid.
3. **MIKRO FIRST ISLAMIC Bosnia & Herzegovina** will be kept regularly informed on repayments.
4. If we do not obey properly this administrative ban, or if we do not forward it immediately to another Company in which a person is employed, we promise to compensate for all costs incurred or any other harm that might be caused to MIKRO **FIRST ISLAMIC Bosnia & Herzegovina** in this way.

RECORDED IN ACCOUNTING DEPARTMENT

________________________ Stamp ____________________
Person Responsible Authorised Person

I have received and shall keep a copy of this certificate, and I have registered the above mentioned obligation that will be regularly carried out by me, in accordance with the decision on general conditions on the loan and in line with the agreement on approved loan.

____
Place and date

Appendix 8: Promissory Note

(Should be translated into local language)

In the amount of __________________ KM

Loan beneficiary: ________________________________ from ___________________
(Name and surname)
ID No: ______________ issued in ___________________ UPN* ___________________

Hereinafter referred to as the loan hereby promises to repay in full to Mikro FIRST ISLAMIC Bosnia & Herzegovina without reservation the whole value of the loan as well as any administrative cost incurred by Mikro FIRST ISLAMIC Bosnia & Herzegovina in disbursing the said loan. All repayments should be in cash. This promissory note shall cover the repayment of the loan from the date of receiving the loan until the date of its repayment. If the loanee fails to comply with all obligations contained in the Loan Agreement Number __________ that accompanies this loan, then Mikro FIRST ISLAMIC Bosnia & Herzegovina reserves the right to request the whole of the remainder of the loan to be repaid immediately and without condition. In the event that the loanee fails to repay any part of the loan, the undersigned signatories guarantee that they will repay the loan themselves to Mikro FIRST ISLAMIC Bosnia & Herzegovina.

1.____________________________ ID No. __________ issued in ________________

2.____________________________ ID No. __________ issued in ________________

The loanee and both guarantors hereby renounce any future protests and objections.

Place and date of issuing the Promissory Note __________________________ , ________________

Issuer: ______________________________ ID No. ________________

1. Guarantor _______________________________ ID No. ________________
2. Guarantor _______________________________ID No. _________________

*Unique Personal Number

Appendix 9: Borrower Declaration

I ________________________________ hereby state that I accept all moral, material and penal responsibility for fulfilling of the requirements contained in the contract no.___________, dated __________________ for a loan received from the microfinance organisation “START” based in the town of Drenas, Kosovo.

Specifically I accept all responsibilities to repay the loan according to Article 140 of KPL (Kosovo Penal Law) for Manipulation and Article 176 of KPL for Untruthful declaration when signing a contract for loan. Furthermore, I accept my penal responsibility in the event of providing incorrect data and for any delays associated with repaying my loan instalments on time.

This declaration I accept as being my own and I have signed the same of my own volition and under no duress.

____

Borrower

________________________ ________________________

Place and date START representative

Appendix 10: Job Descriptions

There are three principal positions within Islamic Relief's microfinance programmes in Bosnia & Herzegovina, Kosovo and Pakistan. The responsibilities of each position are listed in the following job descriptions. The responsibilities of the loan officer include:

1. To receive applications for business and/or housing and or other loans from interested persons.
2. To analyse the feasibility of all loan applications and make recommendations.
3. To oversee the process of disbursing loans and collecting repayments from borrowers.
4. To verify use of loan monies.
5. To maintain all proper records and documentation relating to points 1-4 above.
6. Coordinate in the field with local organisations and authorities in maximising the efficiency and success of our loan programmes.
7. To offer suggestions on how to improve or modify the microfinance programme.

The responsibilities of the microfinance coordinator include the following:

1. To produce regular reports concerning the development of the microfinance programme
2. Oversee the day-to-day management of the microfinance programme, including supervision and training of loan officers.
3. To represent FIRST ISLAMIC BiH and/or Islamic Relief in meetings and communication with external organisations in all activities pertaining to the microfinance programme.
4. To ensure that FIRST ISLAMIC BiH and/or Islamic Relief comply at all times with all legislation and reporting criteria pertaining to our microfinance activities.
5. To offer suggestions on how to improve or modify the microfinance program.

The responsibilities of the accountant include the following:

1. Maintain the microfinance programme's financial and legal records and accounts in a proper manner
2. Withdraw and deposit monies from FIRST ISLAMIC bank accounts as and when necessary to ensure the smooth operation of the microfinance programme.
3. Receive repayments and disburse loans to borrowers.
4. Ensure that FIRST ISLAMIC accounts are maintained appropriately and in compliance with all the relevant local financial and legal regulations and legislation.
5. Inform Islamic Relief's Country Director and Finance officer of any changes in relevant legislation that affect the operations of the microfinance programme.
6. Ensure that the microfinance programme staff's salaries and contributions are paid on time.

Appendix 11: Interviews

Islamic Relief's loan officers regularly conduct in-depth semi-structured qualitative interviews with selected individual borrowers. The interviews are based on the following core open-ended questions:

1. Please tell me if and how your overall economic and social situation for you and your household has changed since you started receiving loans from Islamic Relief?
2. Please tell me if and how your business activities have changed for you and your household since you started receiving loans from Islamic Relief?
3. Please tell me if and how your use of financial services has changed since you started receiving loans from Islamic Relief?
4. Please tell me if and how you have changed as a person since you started receiving loans from Islamic Relief?
5. Please tell me how other members of your household feel since you started receiving loans from Islamic Relief?

Depending upon the answers to the above generative questions, more probing supplementary questions are asked that require respondents to provide more detailed answers. Thus, if the borrower is a woman market stallholder and states that her business has expanded since she started receiving loans from Islamic Relief, we can ask supplementary questions such as whether she sells more products than before, whether she can now pay wholesalers in cash and receive better quality products rather than receive inferior goods on credit, whether she stocks more products than before, whether she has better premises, etc.

Appendix 12: Classifying Loans in Default

In Kosovo Islamic Relief has to classify loans in default according to the criteria laid out by the Banking Authority of Kosovo (BPK) and set aside reserve funds to cover loans in default. This is stipulated according of the BPK Rule IX – Classification of the Banking (Financial Institution) Funds and Security of Loan Loss. On a quarterly basis all financial institutions need to make a classification of the all their loans that are in default according to 5 categories:

1. Standard loans – In this category are loans which are in default up to 30 days and the loan covering fund that needs to be set aside is 1% of the amount unpaid.

2. Observing loans – Loans are placed in this category if the loan is in default for a period of between 31-60 days. The loan covering fund should be at least 5% of the total amount unpaid.

3. Substandard loans- This refers to loans between 61-90 days in default and the covering found should be a minimum of 20%.

4. Suspect loans - This refers to those loans which are in default for between 91-180 days and for this category the covering fund is 50%.

5. Lost loans - This refers to loans that remain unpaid after 180 days. The covering fund should be 100%.